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**ADDIS ABABA UNIVERSITY
FACULTY OF BUSINESS AND ECONOMICS
DEPARTMENT OF ACCOUNTING AND FINANCE
(GRADUATE PROGRAM)**

Perceptions on Internal control system and financial performance; Evidence from commercial banks in Ethiopia

BY:

Seble Worku

June 2018

Addis Ababa

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FACULTY OF BUSINESS AND ECONOMICS
DEPARTMENT OF ACCOUNTING AND FINANCE
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**Perceptions on Internal control system and
financial performance; Evidence from commercial banks in
Ethiopia**

*A Thesis Submitted to the School of Graduate Studies of Addis Ababa University
in Partial Fulfillment of the Requirements for the Degree of Master of Science in
Accounting and Finance.*

BY:
SebleWorku

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Declaration

I, Seble worku, have carried out independently a research work on “Perceptions on Internal control system and financial performance: Evidence from commercial banks in Ethiopia” in partial fulfillment of the requirement of the M.SC program in Accounting and Finance with the guidance and support of the research advisor.

This study is my own work that has not been submitted for any degree program in any other university and that all sources of materials used for the thesis have been duly acknowledged.

Declared By:

Seble worku Signature_____ Date_____

Confirmed by Advisor:

Wollela Abehodie(PhD) Signature_____ Date_____

Certification

This is to certify that Seble worku has carried out her research work on the topic entitled ““Perceptions on Internal control system and financial performance””. The work is original in nature and is suitable for the submission for the reward of MSc Degree in Accounting and Finance.

Advisor: Wollela Abehodie (PhD): _____

Place and date of submission: Addis Ababa University, June, 2018

**ADDIS ABABA UNIVERSITY
POST GRADUATE STUDIES
COLLEGE OF BUSINESS AND ECONOMICS
DEPARTMENT OF ACCOUNTING AND FINANCE**

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BY:

Seble Worku

Approved by the Board of Examiners:

AdvisorSignature

ExaminerSignature

Examiner

Signature

ABSTRACT

Internal Control Systems play an important role in every organization as they assist in realization of their performance goals. The main objective of the study was to assess the Perception of internal control systems on financial performance of commercial banks in Ethiopia. The study adopted a mixed research approach. The quantitative component used survey of employees working in 8 commercial banks in Ethiopia. A random sampling of 240 employees in internal audit, finance and internal control departments were covered by the survey; the response rate was 90%. Survey data was collected by use of a structured questionnaire. Multiple regression models were used to test whether internal control activities, risk management, monitoring, corporate governance have any relation with financial performance. As part of the qualitative component interviews with internal audit and internal control manager were held. It was found that internal control systems had a significant relationship with financial performance. The findings of the study suggested that internal control systems especially corporate governance and control activity are important areas that management of commercial banks should give attention to improve financial performance of commercial banks in Ethiopia.

Keywords: Internal control, Monitoring, corporate governance; risk assessment, control activity and financial performance

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LIST OF ACRONYMS AND ABBREVIATIONS

AB = Abay Bank S.C

ADIB =Addis International Bank

AICPA =American Institute of Certified Public Accountants

APB =Auditing Practices Board

AIB =Awash International Bank S.C

BOA =Bank of Abyssinia S.C

BIB =Berehan International Bank S.C

BUIB =Buna International Bank S.C

CBE =Commercial Bank of Ethiopia

COSO =Committee of Sponsoring Organizations

CBO =Cooperative Bank of Oromia S.C

DB =Dashen Bank S.C

DGB =Dehub Global Bank

EB =Enat Bank

FP=Financial performance

GAAPs =Generally Accepted Accounting Principles

ICS =Internal control systems

IAS =International Accounting Standards

LIB =Lion International Bank S.C

NBE =National bank of Ethiopia

NIB =Nib International BankS.C

NIM=Net Interst Margin

OIB =Oromia International Bank S.C

ROA =Return on assets

ROE =Return on Equity

S=Standard deviation

SPSS= *Statistical* Package for the Social Sciences

UB =United Bank S.C

WB =Wogagen Bank S.C

X1 –Control Activities

X2 – Risk Assessment

X3 – Monitoring

X4 – Corporate governance

\bar{x} =Mean

ZB =Zemen Bank S.C

CHAPTER ONE

INTRODUCTION

Statement of accounting standard (SAS, No 55) defines internal control as a combined plan, method and procedures used to safeguard asset, promote efficiency of operation and adherence to prescribed policies and directives. The wider definition of internal control by United Kingdom Auditing practice Committee (UKAPC,1979) defined internal control as the whole system of control, financial and operational in order to carry on business of any enterprise to safe guard asset, ensure the completeness, accuracy of records , detect errors and fraud and ensure timely report of financial information.

On the other hand financial performance can be defined as the process of measuring the results of a firm's policies and operations in monetary terms (Trivedi, 2010). Measuring financial performance represents a vital mechanism for improving the work of organization since these organizations face complicated challenges in delivering their programs and services. To measure the financial performance of organization profitability or liquidity used.

A sound internal control system helps an organization to prevent fraud, errors and minimize wastage. Custody of asset is strengthened; it provides assurance to the management on dependability of accounting data eliminates unnecessary suspicion and helps in maintenance of adequate and reliability data. But now a days in banking area bank fraud are increase and following same pattern and design have been repeatedly committed in the past year (*Hawaz, 2016*) in addition to that the bank branches increased necessitating the appraisal of the adequacy and reliability of records, and overall efficiency of operations that is why the researcher is motivated the present study.

According to Siayor (2010), Internal control systems (ICS) refers to all the policies and procedures (internal controls) adopted by the directors and management of an entity to assist them in achieving their objectives of ensuring, as far as practicable, the orderly and efficient conduct of a business, including adherence to internal policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information. Internal control systems (ICSs) have become so significant due to the increasing number of business failures and some widely publicized frauds. COSO (2013) framework identifies five main elements of an ICS, namely: control environment, risk assessment, control activities, information and communication, and monitoring.

The quality of an organizations ICS has a significant effect on the accuracy of management guidance (Feng&McVay, 2009). Similarly firms that disclose ineffective ICSs have larger tendencies of experiencing management errors in their operation than those firms that report effective ICSs (Feng ., 2009).Furthermore,Johnkan, *et al.*, (2016),Mawanda, *et al.*, (2008), Olaoye, *et al.*,(2009), andMuraleetharan,*et al.*, (2012)inform that the institution and enforcement of proper ICSs was always lead to improved performance. Moreover, it was a general belief that properly institute systems of internal control improve the reporting process and also gives rise to reliable reports which enhances the accountability function of management of an entity (Spira& Page, 2003).Hence it was necessary to review internal control of some organizations and its relation with financialperformance the paper was try to evaluate internal control system and its impact on financialperformance within commercial banks in Ethiopia.

The remaining discussions are organized as follows. Section 1.1 presentsoverview of the banking sector in Ethiopia which is followed by problem statement in section 1.2. Sections 1.3, 1.4 and 1.5provide research objective and hypotheses, significance of the study and scope and limitation of the study respectively. Finally, the organization of the thesis is presented in section 1.6.

1.1 OVERVIEW OF THE BANKING SECTOR IN ETHIOPIA

The Ethiopian banking sector is currently comprised of a central bank (The National Bank of Ethiopia or NBE), two government owned banks and sixteen private banks.

Based on the most recent data, Commercial Bank of Ethiopia (CBE) mobilizes more than 60 percent of total bank deposits, bank loans and foreign exchange. NBE controls the bank's minimum deposit rate, which now stands at 5 percent, while loan interest rates are allowed to float. Real deposit interest rates have been negative in recent years mainly due to inflation.

The state-owned Commercial Bank of Ethiopia (CBE) dominates the market in terms of assets, deposits, bank branches, and total banking workforce. In 2016, CBE merged with another state owned bank, the Construction and Business Bank. The other government-owned specialized bank is the Development Bank of Ethiopia (DBE). The state-owned DBE provides loans to investors in priority sectors. DBE extends short, medium, and long-term loans for viable development projects, including industrial and agricultural projects. DBE also provides other banking services such as

checking and saving accounts to its clients. NBE aims to foster monetary stability and a sound financial system, maintaining credit and exchange conditions conducive to the balanced growth of the economy.

NBE may engage with banks and other financial institutions in the discount, rediscount, purchase, or sale of duly signed and endorsed bills of exchange, promissory notes, acceptances, and other credit instruments with maturity periods not exceeding 180 days from the date of their discount, rediscount, or acquisition by the bank. The bank may buy, sell, and hold foreign currency notes and coins and such documents and instruments, including telegraphic transfers, as they are customarily employed in international payments or transfers of funds. Lack of access to finance is a significant constraint for local businesses. A January 2011 NBE's directive forces banks to purchase central bank bills to the tune of 27% of their loans and advances at an interest of 3% (lower than the cost of funds at 5%) and a maturity of five years. This action constrains banks' liquidity and capacity to supply businesses with needed finance. There is a growing liquidity problem in Ethiopia that is impeding the private sector. To address these problems, NBE reduced reserve and liquidity requirements of banks from 15% and 25% to 10% and 20%, respectively in January 2012 and further reduced the reserve requirement to 5% in March 2013. In 2015, NBE allowed commercial banks to provide mobile banking service and agent banking. Pursuant to NBE's permit, many of the commercial banks added mobile and agent banking in their line of services.¹

1.2 STATEMENT OF THE PROBLEM

Despite the fact that internal control system have been in existence for many years in the banking sector, There have been current cases and stories told about high frequency of fraud. Ethiopian Commercial banks were not left out in this increase in crime – wave problems and banking malpractices, despite the existence of inter-control and devices adopted to detect fraud.

According to Hawaz (2016) in 2012 7 million Ethiopian Birr(ETB)was transferred from the bank into the account of another company and also in 2016 19 million birr(ETB)to the account of a fake company, 5.8 million birr(ETB) to for forged documents transferred from Commercial Bank of Ethiopia to the account of another company. Bank frauds following same pattern and design have been committed in the past years.On the other hand, National Bank of Ethiopia, June 30, 2017 Report,The

¹Ethiopia - Banking Systems | export.gov (https://www.export.gov/article?id=Ethiopia-Bankin_Systems)

significant branch expansion was undertaken by Commercial Bank of Ethiopia (CBE) with 1170 branches, followed by Awash International Bank (316 branches), Oromiya International Bank (223 branches), Dashen Bank (302 branches), United Bank (205 branches), Bank of Abyssinia (233 branches), and Wegagaen Bank (216 branches). The expansion of bank branches do have a number of implications as regards to human as well as physical resources, specifically man power requirement, fixed assets, training of personnel and other similar resource requirements. These in turn create a pressure on the profitability of the bank in general as new branches take time to transform themselves into profit making stage. With the proliferation of banks and also the increase in rural banking, with commercial bank's branches, the volume of accounting records has drastically increased, thereby necessitating the appraisal of the adequacy and reliability of records, and overall efficiency of operations.

Perception of Internal control system and financial performance of commercial banks appears to be unexplored area in Ethiopia. Exceptions that a little bit closed to this study was the research of Rahel (2017) conducted a case study on the role of internal control systems on performance of Ethiopian shipping and logistics service enterprise and Tsedal (2015) conducted a research on the Assessment of Internal Control Effectiveness in Selected Ethiopian Public Universities

The above discussed problems coupled with the gap in the literature as presented in chapter two call for the conduct of a study on the Perception of Internal control system and financial performance of commercial banks in Ethiopia.

1.3 BROAD OBJECTIVE, HYPOTHESES AND RESEARCH QUESTION

The broad objective of this proposed study is to examine the Perception of internal control system on financial performance of commercial banks in Ethiopia.

Based on this broad research objective the following hypotheses (HP) and research questions (RQ) were developed:

H01: There is a relationship between perceived internal control activities and financial performance of commercial banks.

H02: There is a relationship between perceived Risk Assessment and financial performance of commercial banks.

H03: There is a relationship between perceived Monitoring and financial performance of commercial banks.

H04: There is relationship between perceived corporate governance and financial performance of commercial banks.

In addition to the above hypotheses, the study developed the following research question

RQ1. How is the operation of the internal control systems adopted by banks?

1.4 SIGNIFICANCE OF THE STUDY

Significance of this research will include the following such as the study will draw significant recommendation for improving the performance of the banks by modifying the control system, the finding of this research will provide a knowledge base method that will aid in decision making for manager and help recognize internal control faults to prevent any negative consequence, the study will also help other researchers as a source of reference and as a stepping stone for those who want to make further study on the area afterward. Finally, the study will give stake holders in the area the opportunity to gain deep knowledge about the relationship of internal control and financial performance.

1.5 SCOPE AND LIMITATION OF THE STUDY

The research was focus on examining internal control system and its relation on financial performance of commercial banks in Ethiopia. As a result out of seventeen (17) commercial banks Eight (8) banks such as Awash International Bank, Bank of Abyssinia, Commercial Bank of Ethiopia, , Dashen Bank, Nib International Bank, United Bank , Oromia International Bank S.C(OIB),and Wegagaen Bank has randomly selected under this study .

Due to confidentiality policy of banks, the study was limited to the officially disclosed financial data of banks and the personal perception of management and employees of select Ethiopian commercial banks towards the issue.

In addition to that the independent variables used in this study have qualitative nature while the dependent variable (financial Performance) has a quantitative nature, the nature of data type force the research to use primary data necessary to attain the objective of the research, even though financial performance could be measured using secondary data (financial performance) obtained from financial records of commercial banks the researcher found it difficult to use both primary & secondary data in a single model. Using both types of data (Primary & secondary) would make the regression analysis

too complex to estimate the equation & the result could be inconclusive, to resolve this issue the researcher used primary data to represent the perception of internal control system and financial performance in commercial banks.

1.6 ORGANIZATION OF THESIS

The final thesis was organized in five chapters. The first chapter describe introduction,overview of the banking sector in Ethiopia, statement of the problems, objectives of the study, research hypotheses, research question, significance of the study, and scope and limitation of the study. The second chapter, different literatures that was related to the topics of the study reviews and presents. In the third chapter, research design including the methodology adopted and techniques used in data collection and analysis presents. Then, the fourth chapter presents the results and discussion of the study. Finally, the fifth chapter was provided the conclusion and recommendation for the study according to the findings.

CHAPTER TWO

LITERATURE REVIEW

This chapter presents a review of the theoretical and empirical literature on internal control and financial performance. This review of the literature establishes the framework for the current study and provides the deficiencies of the previous studies, which in turn, help in clearly identifying the gap in the literature and formulating research questions for the study. Section 2.1 present the theoretical review while, section 2.2 and 2.3 present the empirical review and knowledge gap and conclusions respectively.

2.1. THEORETICAL REVIEWS

This section was briefly sketch the meaning of internal controls, theories, internal control component, internal control limitation, and internal control and performance. Finally, the concern is to show financial Performance Measures in the Banks and conceptual frame work

2.1.1 INTERNAL CONTROLS: DEFINITION

Accounting principle board (APB) defines internal control as all the policies and procedures (internal records) adopted by the directors and management of an entity to succeed in their objective of ensuring, as far as practicable.

AU Section 319 and Committee of Sponsoring Organizations (COSO) defines internal control as 'a process, effected by the entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives' effectiveness and efficiency of operation, Reliability of financial reporting and Compliance with applicable laws and regulations.

Internal control is a procedure or policy put in place by management to safeguard assets, promote accountability, increase efficiency, and stop fraudulent behavior. In other words, an internal control is a process put in place to prevent employees from stealing assets or committing fraud.

Internal control is a system or plan of accounting and financial organization within a business comprising all the methods and measures necessary for safeguarding its assets, checking the accuracy of its accounting data or otherwise substantiating its financial statements, and policing previously adopted rules, procedures, and policies as to compliance and effectiveness. (Merriam-Webster 2018)

2.1.2. INTERNAL CONTROL THEORY

A theory is a “set of interrelated concepts, definitions, and propositions that present a systematic view of events or situations by specifying relations among variables, in order to explain and predict the events or situations” (Van Ryn& Heaney, 1992). Theoretical literature is concerned primarily with theories or hypotheses rather than Practical application. Theoretical literature begins with a formal model that seeks to explain participation patterns in terms of underlying theory (Heilbrun& Gray, 1993) based on these the following theories are discussed below

AGENCY THEORY

Agency theory is a management and economic theory that attempts to explain relationships and self-interest in business organizations. It describes the relationship between principals/agents and delegation of control. It explains how best to organize relationships in which one party (principal) determines the work and which another party (agent) performs or makes decisions on behalf of the principal (Jensen and Meckling, 1976).

Agency Theory explains how to best organize relationships in which one party determines the work while another party does the work. In this relationship, the principal hires an agent to do the work, or to perform a task the principal is unable or unwilling to do. For example, in corporations, the principals are the shareholders of a company, delegating to the agent *i.e.* the management of the company, to perform tasks on their behalf. Agency theory assumes both the principal and the agent are motivated by self-interest. This assumption of self-interest dooms agency theory to inevitable inherent conflicts. Thus, if both parties are motivated by self-interest, agents are likely to pursue self-interested objectives that deviate and even conflict with the goals of the principal. Yet, agents are supposed to act in the sole interest of their principals. This position was supported by Coarse (1937) who maintained that the controls provide for conflict resolution between the agent and principal and that moral hazard and adverse selection affects the output of the agent. Studies have shown that Agency theory has been used to explain demands for monitoring controls (Watts & Zimmerman, 1983)

Internal control systems have been incorporated into policies, rules and regulations of organizations to achieve their established objectives. This theory is important in the current study as it will shed light on how the principal and agency interact for the benefit of the organization. It will also help in the

evaluation of the organization on internal controls. The fact that the principal delegates his power to the agent also creates an oversight role by the principal to the agent.

THEORY OF THE FIRM

The theory of the firm is the microeconomic concept founded in neoclassical economics that states that firms (including businesses and corporations) exist and make decisions to maximize profits. Firms interact with the market to determine pricing and demand and then allocate resources according to models that look to maximize net profits.

In the theory of the firm, the behavior of a particular business entity is said to be driven by profit maximization. This theory governs decision making in a variety of areas including resource allocation, production technique, pricing adjustments and quantity produced.

Modern takes on the theory of the firm take such facts as low equity ownership by many decision makers into account; some feel that chief executive officers (CEOs) of publicly held companies are interested in profit maximization as well as in goals based on sales maximization, public relations and market share. Solely focusing on profit maximization comes with a level of risk in regards to public perception and a loss of a sense of goodwill between the business and other individuals or entities.

Further risk exists when a firm focuses on a single strategy within the marketplace. If a business relies on the sale of one particular good for its overall success, and the associated product fails within the marketplace, this can lead to a financial collapse of that particular company or department within a company.

According to Spulber (2009) the theory of the firm consists of a number of economic theories that explain and predict the nature of the firm, company, or corporation, including its existence, behavior, structure, and relationship to the market. According to Magu & Kibati (2016) cited as DePaula (1990) in support stated that risk assessment is important for the existence of the firm. Millichamp (1999) in support stated that monitoring of firm's activities reduces risk of intentional manipulation of accounts and increases element of checking. This makes fraud more difficult to be committed and maximizes profits of the firm. This theory is important in the current research project as it helped in shedding light on how wealth maximization can be achieved through the interaction with internal controls. It also helped in the understanding of the controls activities that are supposed to be put in place to enhance wealth creation.

2.1.3 INTERNAL CONTROL COMPONENTS

The components of internal control are no different in many sources. Some sources refer them the elements or frameworks while some other refer it standards of internal control. The Committee of Sponsoring Organizations (COSO), Act of Sarbanes Oxley and American Institute of Certified Public Accountants (AICPA) claim effective internal control should primarily have five elements namely; control environment, control activities, risk assessment, information and communication, and monitoring. Each of the elements was discussed as follows.

A. CONTROL ACTIVITY

Control activities are the actions established through policies and procedures that help ensure that management's directives to mitigate risks to the achievement of objectives are carried out. Control activities are performed at all levels of the entity, at various stages within business processes, and over the technology environment. They may be preventive or detective in nature and may encompass a range of manual and automated activities such as authorizations and approvals, verifications, reconciliations, and business performance reviews. Segregation of duties is typically built into the selection and development of control activities. Where segregation of duties is not practical, management selects and develops alternative control activities. (COSO2013)

According to the frame work for internal control system in banking organization (1998) stated that control activities should be an integral part of the daily activities of a bank. An effective internal control system requires that an appropriate control structure is set up, with control activities defined at every business level. These should include: top level reviews; appropriate activity controls for different departments or divisions; physical controls; checking for compliance with exposure limits and follow-up on non-compliance; a system of approvals and authorizations; and, a system of verification and reconciliation. An effective internal control system requires that there is appropriate segregation of duties and those personnel are not assigned conflicting responsibilities. Areas of potential conflicts of interest should be identified, minimized, and subject to careful, independent monitoring.

B. RISK ASSESSMENT

Every entity faces a variety of risks from external and internal sources. Risk is defined as the possibility that an event will occur and adversely affect the achievement of objectives. Risk assessment involves a dynamic and iterative process for identifying and assessing risks to the achievement of objectives. Risks to the achievement of these objectives from across the entity are considered relative to established risk tolerances. Thus, risk assessment forms the basis for determining how risks will be managed.

A precondition to risk assessment is the establishment of objectives, linked at different levels of the entity. Management specifies objectives within categories relating to operations, reporting, and compliance with sufficient clarity to be able to identify and analyze risks to those objectives. Management also considers the suitability of the objectives for the entity. Risk assessment also requires management to consider the impact of possible changes in the external environment and within its own business model that may render internal control ineffective. (COSO2013)

According to the frame work for internal control system in banking organization (1998) stated that effective risk assessment identifies and considers internal factors (such as the complexity of the organization's structure, the nature of the bank's activities, the quality of personnel, organizational changes and employee turnover) as well as external factors (such as fluctuating economic conditions, changes in the industry and technological advances) that could adversely affect the achievement of the bank's goals. This risk assessment should be conducted at the level of individual businesses and across the wide spectrum of activities and subsidiaries of the consolidated banking organization. This can be accomplished through various methods. Effective risk assessment addresses both measurable and non-measurable aspects of risks and weighs costs of controls against the benefits they provide. The risk assessment process also includes evaluating the risks to determine which are controllable by the bank and which are not. For those risks that are controllable, the bank must assess whether to accept those risks or the extent to which it wishes to mitigate the risks through control procedures. For those risks that cannot be controlled, the bank must decide whether to accept these risks or to withdraw from or reduce the level of business activity concerned.

According to J. Dubihlela and Lisa (2017) stated that risk management activities protect the organization, its people, assets, and profits, against the physical and adverse consequences, by planning, coordinating and directing the internal risk control and the risk mitigation activities.

C. MONITORING

Ongoing evaluations, separate evaluations, or some combination of the two are used to ascertain whether each of the five components of internal control, including controls to affect the principles within each component, is present and functioning. Ongoing evaluations, built into business processes at different levels of the entity, provide timely information. Separate evaluations, conducted periodically, will vary in scope and frequency depending on assessment of risks, effectiveness of ongoing evaluations, and other management considerations. Findings are evaluated against criteria established by regulators, recognized standard-setting bodies or management and the board of directors, and deficiencies are communicated to management and the board of directors as appropriate. (COSO2013)

According to the frame work for internal control system in banking organization (1998) stated that the overall effectiveness of the bank's internal controls should be monitored on an ongoing basis. Monitoring of key risks should be part of the daily activities of the bank as well as periodic evaluations by the business lines and internal audit. Since banking is a dynamic, rapidly evolving industry, banks must continually monitor and evaluate their internal control systems in the light of changing internal and external conditions, and must enhance these systems as necessary to maintain their effectiveness. Monitoring the effectiveness of internal controls can be done by personnel from several different areas, including the business function itself, financial control and internal audit. For that reason, it is important that senior management makes clear which personnel are responsible for which monitoring functions. Monitoring should be part of the daily activities of the bank but also include separate periodic evaluations of the overall internal control process. The frequency of monitoring different activities of a bank should be determined by considering the risks involved and the frequency and nature of changes occurring in the operating environment. Ongoing monitoring activities can offer the advantage of quickly detecting and correcting deficiencies in the system of internal control. Such monitoring is most effective when the system of internal control is integrated into the operating environment and produces regular reports for review.

D. CORPORATE GOVERNANCE

A bank or financial institution shall establish an effective corporate governance framework which defines the character of the institution and promotes an organizational culture that provides the foundation for effective internal control and internal audit.

According to Jhonkanu (2016) cited as Corporate governance has recently received much attention due to Adelphia, Enron, WorldCom, and other high profile scandals, serving as the impetus to such recent U.S. regulations as the Sarbanes-Oxley Act of 2002, considered to be the most sweeping corporate governance regulation in the past 70 years (Byrnes et al 2003, Nanette et al 2003, Dwyer et al 2003, Henry & Thornton et al 2003). Bebchuk, Ferrell and Cohen (2009), show that firms with stronger stockholder rights have higher Tobin Q's, their proxy for firm value, suggesting that better-governed firms are more valuable.

The code of corporate governance highlights the need for a firm to maintain a good system of internal controls in order to manage the risks that the firm is prone to.

In addition to that control environment and accounting information system and communication was discussed below

The control environment is the set of standards, processes, and structures that provide the basis for carrying out internal control across the organization. The board of directors and senior management establishes the tone at the top regarding the importance of internal control including expected standards of conduct. Management reinforces expectations at the various levels of the organization. The control environment comprises the integrity and ethical values of the organization; the parameters enabling the board of directors to carry out its governance oversight responsibilities; the organizational structure and assignment of authority and responsibility; the process for attracting, developing, and retaining competent individuals; and the rigor around performance measures, incentives, and rewards to drive accountability for performance. The resulting control environment has a pervasive impact on the overall system of internal control. (COSO2013)

Information is necessary for the entity to carry out internal control responsibilities to support the achievement of its objectives. Management obtains or generates and uses relevant and quality information from both internal and external sources to support the functioning of other components of internal control. Communication is the continual, iterative process of providing, sharing, and obtaining necessary information. (COSO2013)

According to the frame work for internal control system in banking organization (1998) stated that adequate information and effective communication are essential to the proper functioning of a system of internal control. From the bank's perspective, in order for information to be useful, it must be relevant, reliable, timely, accessible, and provided in a consistent format. Information includes internal financial, operational and compliance data, as well as external market information about events and

conditions that are relevant to decision making. Internal information is part of a record-keeping process that should include established procedures for record retention.

2.1.4. LIMITATIONS OF INTERNAL CONTROL SYSTEMS

Internal control provides reasonable assurance of achieving the entity's objectives, limitations do exist. Internal control cannot prevent bad judgment or decisions, or external events that can cause an organization to fail to achieve its operational goals. In other words, even an effective system of internal control can experience a failure. Limitations may result from the suitability of objectives established as a precondition to internal control, reality that human judgment in decision making can be faulty and subject to bias, breakdowns that can occur because of human failures such as simple errors, ability of management to override internal control, ability of management, other personnel, and/or third parties to circumvent controls through collusion and external events beyond the organization's control. (COSO2013)

These limitations preclude the board and management from having absolute assurance of the achievement of the entity's objectives that is; internal control provides reasonable but not absolute assurance. Notwithstanding these inherent limitations, management should be aware of them when selecting, developing, and deploying controls that minimize, to the extent practical, these limitations.(COSO2013)

2.1.5. PERFORMANCE MEASURES IN COMMERCIAL BANKS

Performance is a measure of company's policies and operations in monetary terms. It is a general measure of a firm's overall financial health over a given period of time, and can be used to compare similar firms across the same industry or to compare industries or sectors in aggregation.

The financial performance analysis identifies the financial strengths and weaknesses of the firm by properly establishing relationship between the items of the statement of financial position and statement of comprehensive income.

According to Dixon (1990) appropriate performance measures are those which enable organizations to direct their actions towards achieving their strategic objectives. Banks ultimate goal is Profit. All activities performed are to realize this grand objective. They also have additional social and economic goals.

Profitability

To measure the financial performance of organization Return on Asset (ROA), Return on Equity (ROE), Net interest margin (NIM) ratio may be used.

Return on Asset (ROA)

Return on assets (ROA), is an indicator of managerial efficiency; it indicates how capable management has been in converting assets into net earnings. ROA is an important indicator to measure the profitability of the organization. It is a ratio of net income after tax to its total assets. ROA tells what the company can do with what it has, *i.e.* how many dollars of earnings they derive from each dollar of assets they control. It's a useful number for comparing competing companies in the same industry. It also measures the ability of the organization management to generate income by utilizing assets at their disposal (Rufai, 2013). The higher ROA shows that the organization is more efficient in using its resources (assets).

Return on Equity (ROE)

ROE is other major ratio that indicates the performance of the organization. Efficiency of organization can be measured by using the ROE which illustrates to what extent organization use reinvested income to generate future profits. A business that has a high return on equity is more likely to be one that is capable of generating cash internally. Thus, the higher the ROE, the better the financial institutions in terms of profit generation. It is the ratio of net Income after taxes divided by total equity capital. According to the study of Joetta (2007) presented the purpose of ROE as the measurement of the amount of profit generated by the equity in the firm. It is also mentioned that the ROE is an indicator of the efficiency to generate profit from equity. This ability is connected to how well the assets are utilized to produce the profits as well.

Net interest Margin (NIM)

It is a measure of the difference between the interest income generated by financial institutions and the amount of interest paid out to their lenders, relative to the amount of their assets. The NIM variable is defined as the net interest income divided by total earnings assets. It is usually expressed as a percentage of what the financial institution earns on loans in a time period and other assets minus the interest paid on borrowed funds divided by the average amount of the assets on which it earned income in that time period (the average earning assets). It measures the gap between the interest income the bank receives on loans and securities and interest cost of its borrowed funds (Khrawish, 2011).

2.1.6 INTERNAL CONTROL SYSTEM AND FINANCIAL PERFORMANCE

Comptroller's Handbook January 2001 stated that Effective internal control provides bankers and examiners reasonable assurance that Bank operations are efficient and effective, recorded transactions are accurate, financial reporting is reliable, risk management systems are effective, the bank complies with banking laws and regulations, internal policies, and internal procedures

According to Basel 1998 a system of strong internal controls can help to ensure that the goals and objectives of a banking organization will be met, that the bank will achieve long-term profitability targets, and maintain reliable financial and managerial reporting.

According to Shafawatyet al, Ram et al; Azizi et al (2016) that cooperative management is confident that the cooperative's profit can be improved with new development plan as well as implementation of more stringent and effective internal control systems in cooperative. Effective internal control systems are believed to have the ability to increase the profitability of cooperatives, which will directly help to promote the stability and growth of the cooperative.

According to Ndiwa and Kwasira (2014) State that institution that had entrenched prudent internal control strategies were most likely to manage their finances better hence meeting their financial and other pertinent obligations almost seamlessly.

According to Rahel (2017) more commitment by the management in monitoring internal control system and continue working on improving for the effectiveness of the internal control system so, the company will achieve better performance.

According to (Dr. Zahid et al, Maha et al, and Irfan et al 2015) stated that a sound system of internal control has a positive relationship with the financial stability of the organization.

According to Davies, 2005 Positive financial performance in a firm can be achieved by eradicating waste in benefits services processes and systems. The "critical success factor" for a firm is the degree to which it fulfills its set objectives and mission in terms of being efficient, effective and economical. The information obtained from a sound internal control system as reflected from financial statements will provide a report on a firm's financial performance and position that is useful to a wide range of users for assessing the stewardship and making economic decisions.

2.2 EMPIRICAL REVIEW

Mawanda (2008) conducted a research on effects of internal control systems on financial performance in institution of higher learning Uganda. In his study he investigated and sought to establish the

relationship between internal control systems and financial performance in an Institution of higher learning in Uganda. Control Environment, Internal Audit and Control Activities were taken as independent variable while financial performance Liquidity, Accountability and Reporting was taken as dependent variable representing the firm's performance. The Researcher set out to establish the causes of persistent poor financial performance from the perspective of internal controls. The study established a significant relationship between internal control system and financial performance.

A case study was conducted by Mary and Byaruhanga (2014) in their study they investigated and sought to establish the relationship between internal control component and financial performance of Kenya's sugar cane out grower companies. Internal controls were looked at from the perspective of control environment, risk assessment process, information system and control activities whereas financial performance focused on cost per unit, goal attainment and profitability as the measures of financial performance as a result of poor performance of the management which is illustrated in poor returns they post for their clients. The study result indicates internal control system has positive significant impact on financial performance

Kamau (2014) conducted a research on the effect of internal control system on financial performance of manufacturing firms in Kenya. The study examined the effect of control activities on the financial performance of manufacturing firms in Kenya. The results revealed that the staffs were trained to implement the accounting and financial management systems, the security system identified safeguarded organizational assets and also the management had put in place mechanisms for mitigation of critical risks that may result from fraud. The statistical results from the regression analysis show that there is a positive relationship between internal control and financial performance of manufacturing firms in Kenya. Internal control proxy by Control Environment, Risk Assessment, Control Activities, Information and Communication, and monitoring contributed to a good model prediction.

Researchers Nyakundi and Tinega (2014) made a study with the objective of investigating the effect of internal control systems on financial performance among small and medium enterprise in kisumu city, Kenya. Internal controls were looked at from the perspective of Control Environment, control activities and monitoring of controls whereas financial performance focused on Return on Investment as the measures of financial performance. The study concluded that internal control systems as supported by the study findings significantly influence the financial performance of SMEs. However, there are challenges in the implementation of internal controls especially considering that the

internal audit function which is the backbone of internal controls is not adequately equipped by the technical manpower required, which clearly has affected their efficiency as revealed by this study. Inadequate financial resources have also accelerated to their inefficiency, reflected by irregular audit activities as well as absence of regular reports.

Ndifon and Patrick (2014) studied the Impact of Internal Control Activities on Financial Performance of Tertiary Institutions in Nigeria. The objective of this study is to establish the relationship between internal control activities and financial performance in Tertiary Institutions in Nigeria. The data for the study was collected using questionnaire and interview. The study revealed that all activities of the College are initiated by the top management, there is clear separation of role in the institutions' finance and account department and that superior officer in the College supervised regularly work done by their subordinate, the institution financial statements are audited annually by external. However, there is a possibility for a single staff to have access to all valuable financial information without the consent of other staff. On the budgetary control, the study revealed that the institution adhere strictly to the provisions of annual departmental budget and that control are in place to exclude incurring expenditure in excess of allocated fund. Also, there is poor security network in the College. The study result further shows that, there is no significant relationship between internal control activities and financial performance of Cross River College of Education.

Chnna (2015) studied comparative assessment on internal control effectiveness and its impact on financial performance. The study examined the relationship between internal control effectiveness with the proxy control environment, risk assessment, control activity, information and communication and monitoring and financial performance with the proxy of ROA, ROE and profit to expense ratios among private, public and Islamic banks. The studied results shows that the effectiveness of the elements of the internal control system vary between banks in the same sector the general result reveals there is no significant variation about effectiveness of the elements of internal control system among different sector of banks. And also financial performance between groups and within groups concluded even though still there is variation of performances within groups, the total result shows banks engaged in different sectors do not have significant variation in their ROA, ROE and profit to expense measures.

Hassen (2016) in their study they investigated and sought to establish the relationship between the internal control system and organizational performance of remittance companies in Mogadishu-

Somalia. In this study internal control system proxy by control environment, control activities and risk evaluation whereas organizational performance on Employee Satisfaction and Customer Satisfaction. Tools of this research were questionnaires which are administered through drop and pick method. Findings showed that control environment; risk assessment and control activity significantly affects the organizational performance of remittance companies in Mogadishu.

Magu&Kibati (2016) made a study on the influence of internal control system on financial performance of Kenya Farmers' Association Limited. In his study he investigated and sought to establish the influence of internal control system on the financial performance of KFA Ltd. In this study, Internal controls were looked at from the perspective of control environment and control activities whereas financial performance on liquidity, financial report and accountability. The results revealed that the staffs were not trained to implement the accounting and financial management systems; and that the security systems do not identify and safeguard organizational assets. The results further showed that there is a positive relationship between internal control systems and financial performance.

Robert (2016) conducted a research on Internal Control System and Financial Performance in Non-Governmental Organizations in Uganda: A Case Study of International Union for Conservation of Nature. The study set out to investigate the role of internal control system in the financial performance of non-governmental organizations in Uganda. Specifically the study sought to establish the effect of control environment on the financial performance of International Union for Conservation of Nature, to investigate the effect of control activities on the financial performance of International Union for Conservation of Nature, and to examine the significance of monitoring on the financial performance of International Union for Conservation of Nature. The findings of the study revealed a significant relationship between control environment, control activities, monitoring, and financial performance.

Johnkan (2016) conducted a research on effect of internal control system on financial performance of companies quoted in the Nairobi securities exchange (NSE). The main objective of the study was to the effect of internal control systems and financial performance of companies quoted in NSE. Internal controls were looked at from the perspective of internal control environment, internal audit function, risk management, internal control activity and corporate governance whereas financial performance focused on Net profit, Return on equity and Earning per share as the measures of financial performance. The study adopted descriptive research design using both quantitative and qualitative

approach and multiple regression model used. The data was analyzed using both qualitative and quantitative analysis. The finding of the study revealed that internal control systems had a significant relationship with financial performance.

Kingsley (2018) studied Relationship between adoption of enterprise risk management (ERM) practices and firm performance in Sri Lankan Banking and Finance Industry. The study used Return on equity (ROE) as a proxy to measure the firm performance and enterprise risk management used as independent variable. The study employed a multivariate regression analysis to assess the impact of key ERM functions on firm performance. Event identifications, risk assessment, risk response and information & communication indicate a positive impact on firm performance. Surprisingly, empirical evidence reveals that objective setting; event identification, control activities and monitoring of ERM functions have a negative impact on the firm performance.

A few related studies were conducted by few researchers in Ethiopia. Tsedal (2015) conduct a research on the Assessment of Internal Control Effectiveness in Selected Ethiopian Public Universities. Internal controls were looked at from the perspective of Control Environment, Control Activities, Risk Assessment, Information and Communication system, and Monitoring .Thus this study focused on assessment of the effectiveness of the internal control system in the universities to identify the possible areas of deficiencies in the system. Data were analyzed using descriptive statistics and inferential statistics using SPSS results. The result indicates that internal control in the universities is not effective. Particularly the risk assessment component of internal control is not practiced in the universities. Though monitoring is better in the universities, there is inadequate control environment, control activities and inadequate flow of information and communication in those universities. Hence, it needs commitment from both universities management and responsible government authorities to improve those specific areas of deficiencies' in internal control indicated.

Rahel (2017) conduct a research on the role of internal control systems on performance of Ethiopian shipping and logistics service enterprise. The main purpose of this study was to determine the impact of internal control systems on financial performance on Ethiopian shipping and Logistics Services Enterprises as a case study. Internal controls were looked at from the perspective of internal control system, control environment, control activities, risk assessment, monitoring and information and communication whereas financial performance focused on profitability and ROA. The descriptive result shows there is weak internal control system in the organization. The study recommend more commitment by the management in monitoring internal control system and continue working on

improving for the effectiveness of the internal control system so, the company will achieve better performance.

2.3 CONCLUSIONS AND KNOWLEDGE GAPS

In general the literature indicates that organizations should invest heavily on the internal control and used to improve the quality of their internal control systems. The devotion of resources, knowledge, time and human power is needed, notably: good internal control is good business by itself. It helps organizations ensure that operating, financial and compliance objectives are met.

Some of studies investigated the relationship between the internal control systems and financial performance in different countries e.g. Uganda, India, Kenya and Nigeria. And also prior researches have documented different results on the evidence of the linkage between internal control systems and financial performance. In the context of Ethiopia, the related study conducted by Rahel (2017) tries to see the role of internal control system on performance of Ethiopian shipping and logistics service enterprise by considering internal control from the perspective of Control Environment, Control Activities, Risk Assessment, Information and Communication system, Monitoring and fail to disclose the impact of corporate governance on financial performance. To the knowledge of the researcher, there appear to be no other studies that looked at the impact of internal controls on banks' financial performance in Ethiopia. In this context it is important to assess the relationship between internal controls and financial performance of commercial banks in Ethiopia.

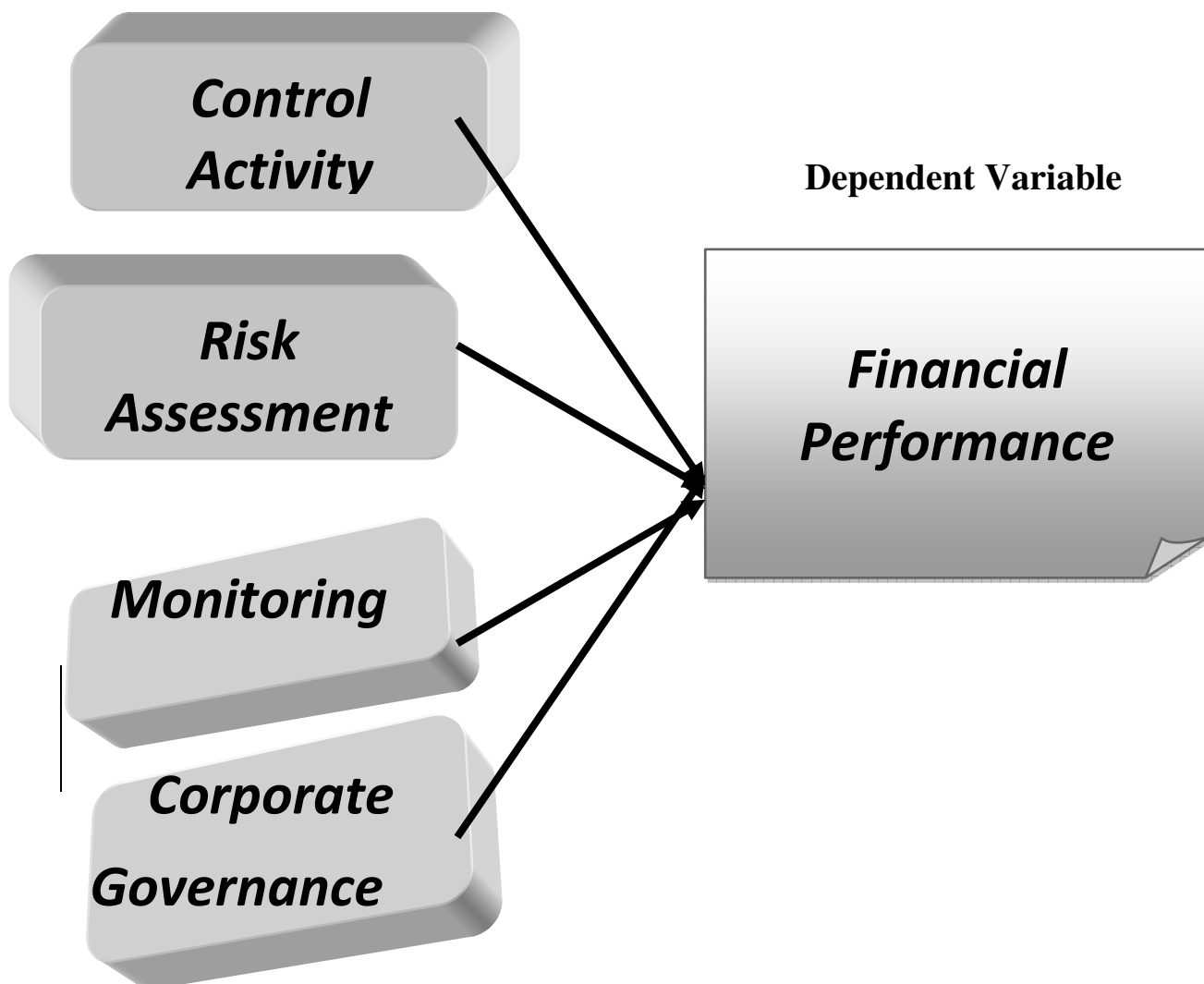
Lastly, the next chapter discusses about the research methodology that are applied for the study along with proper justification for the selection of appropriate research methods.

CONCEPTUAL FRAMEWORK

Based on the review of both theoretical and empirical studies on internal controls and financial performance the following conceptual framework guiding this study was developed.

Figure2.1. Conceptual Framework

Independent Variables



Source: Developed by the researcher based on both theoretical and empirical Literature review

CHAPTER THREE

RESEARCH METHODOLOGY

This chapter describes the research methodology of the study that was used to achieve the objective of the study. Research methodology is the procedural plan that was adopted by the researcher to validly, objectively, economically and accurately answer the research questions. The chapter was organized in four sections. The first section 3.1 was present the objective, research questions and hypotheses. This was followed by a discussion of the research approaches in section 3.2 .Section 3.3 was presented methods adopted and assessment of data. Finally summary and the link between research questions and hypotheses and the different data sources were presented in section 3.4.

3.1 RESEARCH OBJECTIVE, HYPOTHESES, AND QUESTION

As it was indicated in chapter one the broad objective of this study was to examine the perception of internal control system and financial performance of commercial banks in Ethiopia. Consequently, to address the broad objective of the research a series of research questions and hypotheses was developed,

Research Hypotheses

AU Section 319 stated that control activities include reviews of actual performance versus budgets, forecasts, and prior period performance; relating different sets of data—operating or financial—to one another, together with analyses of the relationships and investigative and corrective actions; and review of functional or activity performance, information processing (necessary to check accuracy, completeness and authorization of transactions), physical controls (necessary to provide security over both records and other assets), and segregation of duties (where no one person should handle all aspects of a transaction from the beginning to the end). According to Ndifon and Patrick (2014), there is no significant relationship between control activities and performance of the organizations. On the other hand, According to Hassan (2016) there is a positive relationship between control activities and performance. Hence, based on the arguments above, the following hypothesis was proposed:

H01: There is a relationship between perceived internal control activities and financial performance of commercial banks.

Risk assessment is the identification and analysis of relevant risks to Achievement of the objectives, forming a basis for determining how the risks should be managed. Because economic, industry,

regulatory and operating conditions will continue to change, mechanisms are needed to identify and deal with the special risks associated with change. Every entity faces a variety of risks from external and internal sources that must be assessed. A precondition to risk assessment is the establishment of objectives, linked at different levels and internally consistent. The purpose of an entity's risk assessment is to identify, assess, and manage risks that affect the entity's ability to accomplish its major objectives. According to Rhale (2017), there is no significant relationship between Risk assessment and performance of the organizations. On the other hand, According to Hassan (2016) there is a positive relationship between Risk assessment and performance. Hence, based on the arguments above, the following hypothesis was proposed:

H02: There is relationship between perceived Risk Assessment and financial performance of commercial banks.

Internal control systems need to be monitored — a process that assesses the quality of the system's performance over time. This is accomplished through ongoing monitoring activities, separate evaluations or a combination of the two. Ongoing monitoring occurs in the course of operations. It includes regular management and supervisory activities, and other actions personnel take in performing their duties. According to Kingsley (2018) monitoring of enterprise risk management functions has a negative impact on the firm performance. On the other hand, According to Rhale (2017), there is significant relationship between Monitoring and performance of the organizations. Hence, based on the arguments above, the following hypothesis was proposed:

H03: There is relationship between perceived Monitoring and financial performance of commercial banks.

A bank or financial institution shall establish an effective corporate governance framework which defines the character of the institution and promotes an organizational culture that provides the foundation for effective internal control and internal audit.

Corporate governance has recently received much attention due to Adelphia, Enron, WorldCom, and other high profile scandals, serving as the impetus to such recent U.S. regulations as the Sarbanes-Oxley Act of 2002, considered to be the most sweeping corporate governance regulation in the past 70 years (Byrnes, Nanette, Dwyer, Henry & Thornton, 2003). With recent regulations focusing on corporate governance, such as those based on the Sarbanes-Oxley Act and the recent stock listing standards imposed by major U.S. Exchanges, there is a widely held view that better corporate

governance is associated with better firm financial performance, but the evidence is tenuous (LeBlanc and Gillies, 2003). Hence, based on the arguments above, the following hypothesis was proposed:

H04: There is relationship between perceived corporate governance and financial performance of commercial banks.

In addition to the above hypotheses the following question was developed:

RQ1. How is the operation of the internal control systems adopted by banks?

3.2 RESEARCH APPROACHES

Research approaches are plans and the procedures for research that span the steps from broad assumptions to detailed methods of data collection, analysis, and interpretation. . The research approach implicitly reflects the researcher attitude as to how knowledge is constructed and also commands what method to be employed in the study. According to (Creswell 2014), Quantitative, qualitative and mixed methods based their assumption towards knowledge creation on post-positivism, social constructivism and pragmatic philosophical grounds respectively.

- A Quantitative research is an approach for testing objective theories by examining the relationship among variables. These variables, in turn, can be measured, typically on instruments, so that numbered data can be analyzed using statistical procedures. The final written report has a set structure consisting of introduction, literature and theory, methods, results, and discussion. Like qualitative researchers, those who engage in this form of inquiry have assumptions about testing theories deductively, building in protections against bias, controlling for alternative explanations, and being able to generalize and replicate the findings. (Creswell 2014)

- A Qualitative research is an approach for exploring and understanding the meaning individuals or groups ascribe to a social or human problem. The process of research involves emerging questions and procedures, data typically collected in the participant's setting, data analysis inductively building from particulars to general themes, and the researcher making interpretations of the meaning of the data. The final written report has a flexible structure. Those who engage in this form of inquiry support a way of looking at research that honors an inductive style, a focus on individual meaning, and the importance of rendering the complexity of a situation. (Creswell, 2014)

Finally, a mixed methods research is an approach to inquiry involving collecting both quantitative and qualitative data, integrating the two forms of data, and using distinct designs that may involve philosophical assumptions and theoretical frameworks. The core assumption of this form of inquiry is

that the combination of qualitative and quantitative approaches provides a more complete understanding of a research problem than either approach alone. (Creswell, 2014)

3.3 RESEARCH METHODS ADOPTED

In this study, a mixed research methods approach was adopted. A mixed methods design is useful to capture the best of both quantitative and qualitative approaches. In light of the research objectives, the study was employed both qualitative and quantitative research approach, i.e., self-administrated questionnaires and interview. Therefore, using both approaches is helpful for generating the benefits of a mixed methods approach presented earlier and mitigating the bias in adopting only either quantitative or qualitative approach. Hence, in this study, concurrent procedure was employed to triangulate quantitative and qualitative data to provide a comprehensive analysis of the research problem. Moreover, the researcher was collected both forms of data at the same time during the study and integrates the information in the interpretation of the overall results. The following sub-sections orderly the quantitative and qualitative aspects of the study.

3.3.1 QUANTITATIVE ASPECT—SURVEY

The quantitative component intends to investigatory primarily uses post-positive claims for developing knowledge from cause and effect thinking, reduction to specific variables and hypotheses and questions, use of measurement and observation, and the test of theories, employees strategies of inquiry such as experiments and surveys. As part of the quantitative component of the study survey design was adopted as a strategy of inquiry. The purpose of the survey design is to generalize from a sample to a population so that inferences can be made about some characteristic, attitude, or perception of the population. The advantages of survey designs are the economy of the design and the rapid turnaround in data collection. The subsequent discussion shows the survey design in respect to population and sampling design, instrument and conduct of survey, definition and measurement of variables and model specification, and ordinary least square assumptions.

3.3.1.1 POPULATION AND SAMPLING DESIGN

The target population of this study was commercial banking sector in Ethiopia. According to national bank of Ethiopia (NBE) annual report 2015-2016, the numbers of commercial banks are 17. These are Abay Bank S.C (AB), Addis International Bank (ADIB), Awash International Bank S.C (AIB), Bank of Abyssinia S.C (BOA), Berehan International Bank S.C (BIB), Buna International Bank S.C (BUIB),

Commercial Bank of Ethiopia (CBE), Cooperative Bank of Oromia S.C (CBO), Dashen Bank S.C (DB), Debu Global Bank (DGB), Enat Bank (EB), Lion International Bank S.C (LIB), Nib International Bank S.C (NIB), Oromia International Bank S.C (OIB), Wogagen Bank S.C (WB), United Bank S.C (UB) and Zemen Bank S.C (ZB) from the above list one bank is Publically owned and the remaining sixteen are privately owned . On this study the researcher was focused on commercial banks.

According to Faber and Fonseca (2014), sample shouldn't be too large to be economical and shouldn't be too small to keep validity of findings. Accordingly this study was used two sampling stages. The first one is to sample out the commercial banks and secondly the number of respondents within the commercial banks. According to national bank of Ethiopia (NBE) annual report 2015-2016, the numbers of commercial banks are 17. From the existing 17 commercial banks in Ethiopia, eight commercial banks were selected under this study. Because Kothari's (2004) recommended that a sample of 10% to 30% of the target population was a sufficient representation of the population. The name of the selected commercial banks are; Awash International Bank, Bank of Abyssinia, Commercial Bank of Ethiopia, Dashen Bank, Nib International Bank, United Bank, Oromia International Bank and WogagenBank.

There were 504 employees working at head offices in finance, internal control and internal audit departments. Out of potential participants in the population, 240 respondents were selected from eight commercial banks. Because Kothari's (2004) recommended that a sample of 10% to 30% of the target population was a sufficient representation of the population. The focus was at the head office level because branches were expected to exhibit similar nature as operations at head offices.

Table 3.1: Sampled Commercial Banks of the Study

S/N	Name of Bank	Number of internal audit, finance and internal control department employees at Head Office	Proportionally taken Samples (47.6%)
1	Awash International Bank (AIB)	50	24
2	Bank of Abyssinia (BoA)	41	19
3	Commercial Bank of Ethiopia (CBE)	154	73
4	Oromia International Bank (OIB)	48	22
5	Dashen Bank (DB)	60	29
7	Nib International Bank (NIB)	42	20
8	United Bank (UB)	60	29
9	Wegagen International Bank (WIB)	49	24
	Total	504	240

Source: Henok(2017) and Human resource

3.3.1.2 SURVEY INSTRUMENT AND CONDUCT OF THE SURVEY

This study used questionnaire which is a widely used and useful instrument for collecting survey information. The questionnaire was developed in two sections. The first one is on the general aspect of the respondent and the second one was developed based on standard of internal control. The first section was aimed to evaluate whether the status and experience of the respondents has an effect on internal control system. The second section was used to evaluate the effect of the standards of the controls are in those samples of commercial banks. This section uses questions to internal audit, finance and internal control employees with response ranging from strongly agree to strongly disagree. A five point Likert response scale Likert (1932) that ranged from 5 “strongly agree (scored as 5) to “strongly disagree” (scored as 1) was used. The instrument was prepared based on the instrument used by magu and kibati et al 2016, Ndifon and Partic et al 2014, johnkan et al 2016. The questionnaire was prepared in English (see the instrument in appendix I). The survey used self-administration where questionnaires were hand-delivered to respondents for them to complete on their own.

Finally this method of data collection was considered appropriate because the information sought is not publicly available and the internal audit department, finance department, and internal control department employees in the banks were in good position to know the answers to the questions asked.

Out of 240 questionnaires distributed to potential respondents 216 were completed and returned. Based on these completed and returned questionnaires the researcher carried out data reliability using Cronbach's alpha test.

Lee Cronbach (1951) defines Reliability as an attribute of an instrument used to measure consistency. Consistency indicates that an instrument has constructive value it used to measure. A commonly accepted rule of thumb for describing internal consistency using Cronbach's alpha is as follows:-

Table 3.2 Reliability test

Cronbach's alpha	Internal consistency
a = 0.9	Excellent
0.8 = a < 0.9	Good
0.7 = a < 0.8	Acceptable
0.6 = a < 0.7	Questionable
0.5 = a < 0.6	Poor
a < 0.5	Unacceptable

Cronbach alpha for data collected 216 constructs of internal control system is 0.883. This indicates that the survey instrument or the data used are highly consistent because the Cronbach's alpha is ranged in a good measure of internal consistency.

Reliability Statistics

Cronbach's Alpha	N of Items
.883	5

Source; Survey Results and SPSS (2018) output

3.3.1.3 DEFINITION AND MEASUREMENT OF VARIABLES AND MODEL SPECIFICATION

This section presents the definition and measurement of variables; and then specifies the model employed in the analysis.

Definition and Measurement of variables

Dependent variable: performance is a measure of company's policies and operations in monetary terms. It is a general measure of a firm's overall financial health over a given period of time, and can be used to compare similar firms across the same industry or to compare industries or sectors in aggregation. This was measured by responses of study participants to the following 6 items on the five-point scales (strongly disagree (1), disagree (2), neutral (3), agree (4) and strongly agree (5). The average response of profitability in company over the last year, creditor are paid in time to avoid legal charge and net interest margin in company over the last 3 year has been growing steadily was used as a measure of this dependent variable.(For the detail as see appendix V.)

Independent variables

Control activities-These are the policies, procedures and mechanisms put in place to ensure management directives are properly carried out. This was measured by responses of study participants to 7 items on the five-point scales (strongly disagree (1), disagree (2), neutral (3), agree (4) and strongly agree (5). Specifically, the average responses to such statements as "management review financial transactions regularly", "adequate segregation of duties" and "there is an up-to-date asset register" were used as a measure of the variable control activities (see details in appendix V.)

Risk assessment – It entails risk identification, risk evaluation and risk response. This was measured by responses of study participants to the 5 items (as shown in Appendix V) on the five-point scales (strongly disagree (1), disagree (2), neutral (3), agree (4) and strongly agree (5)). Some of these items include “management identifies risks that affect achievement of the objectives”, “management has put in place mechanisms for mitigation of critical risks that may result from fraud”, and “management has a criteria for ascertainment of which fraud-related risks to the organization”.

Monitoring - This is the process of assessing the quality of the internal control structure over time. This was measured by average responses of study participants to the 10 items (shown in Appendix V) on the five-point scales (strongly disagree (1), disagree (2), neutral (3), agree (4) and strongly agree (5)). Among the statements considered, to this end, the following were very important: “independent process checks and evaluations of controls activities on ongoing basis”, “monitoring has helped in assessing the quality of performance of the organization over time”, and “bank’s financial statements are audited regularly by external auditors”.

Corporate governance-Corporate governance is concerned with the processes, systems, practices and procedures that govern institutions. This was measured by average responses of study participants to the 6 statements (please see details in Appendix V) using a five-point Likert scales (strongly disagree (1), disagree (2), neutral (3), agree (4) and strongly agree (5)). Some of the statements considered to this end include: “company has a well-established and effective Board, all members of the board of directors belong to various specialized sub-committee of the board”, and “the different members of the board in the company bring unique experiences and expertise to the management of the company”.

Model specification

Following the approach used in Magu and Kibati et al (2016), Muraleetharan et al (2012), Kamau et al (2014), Johnkan et al (2016) and Rahel (2017), this study used Multiple regression model; the equation is given below:

$$FP = \beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \beta_4X_4 + e$$
 Where,

FP–Financial Performance of commercial banks

β_0 – constant

X1 –Control Activities

X2 – Risk Assessment

X3 – Monitoring

X4 – Corporate governance

$\beta_1 - \beta_4$ = Measure of sensitivity of variable X to changes in P

e=Error term

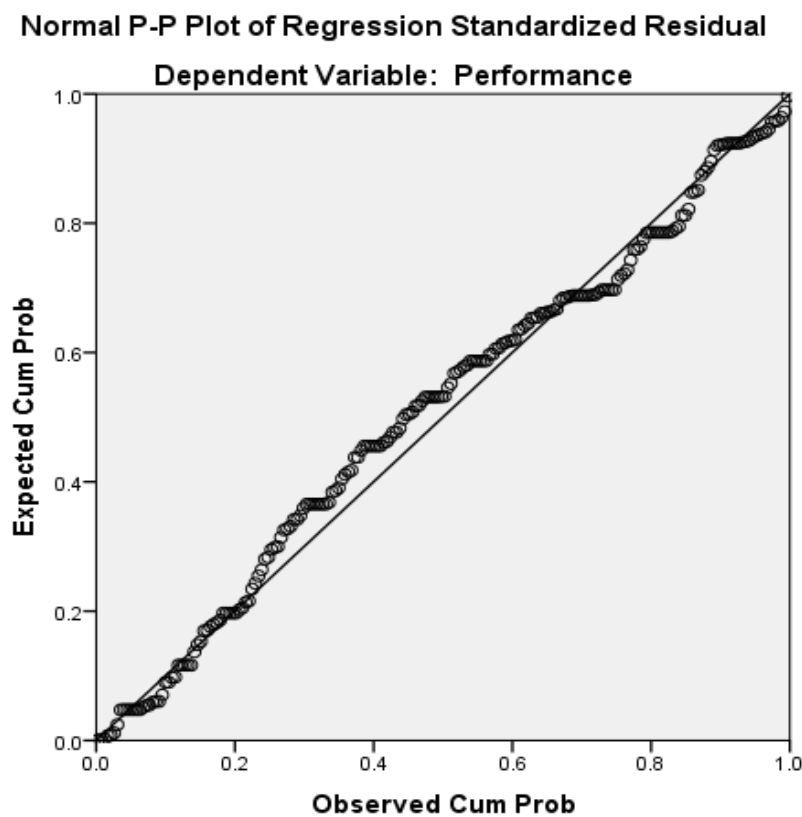
3.3.1.4 ORDINARY LEAST SQUARE ASSUMPTIONS

Under this section present the following test Normality of residuals test, Heteroscedasticity / presence of Homoscedasticity, Multicollinearity, and auto correlation.

Normality of residuals test

We can also check for normality of residuals with a normal P-P plot. The plot shows that the points generally follow the normal (diagonal) line with no strong deviations. This indicates that the residuals are normally distributed.

Figure 3.1 normal P-P plot of regression standardized residual

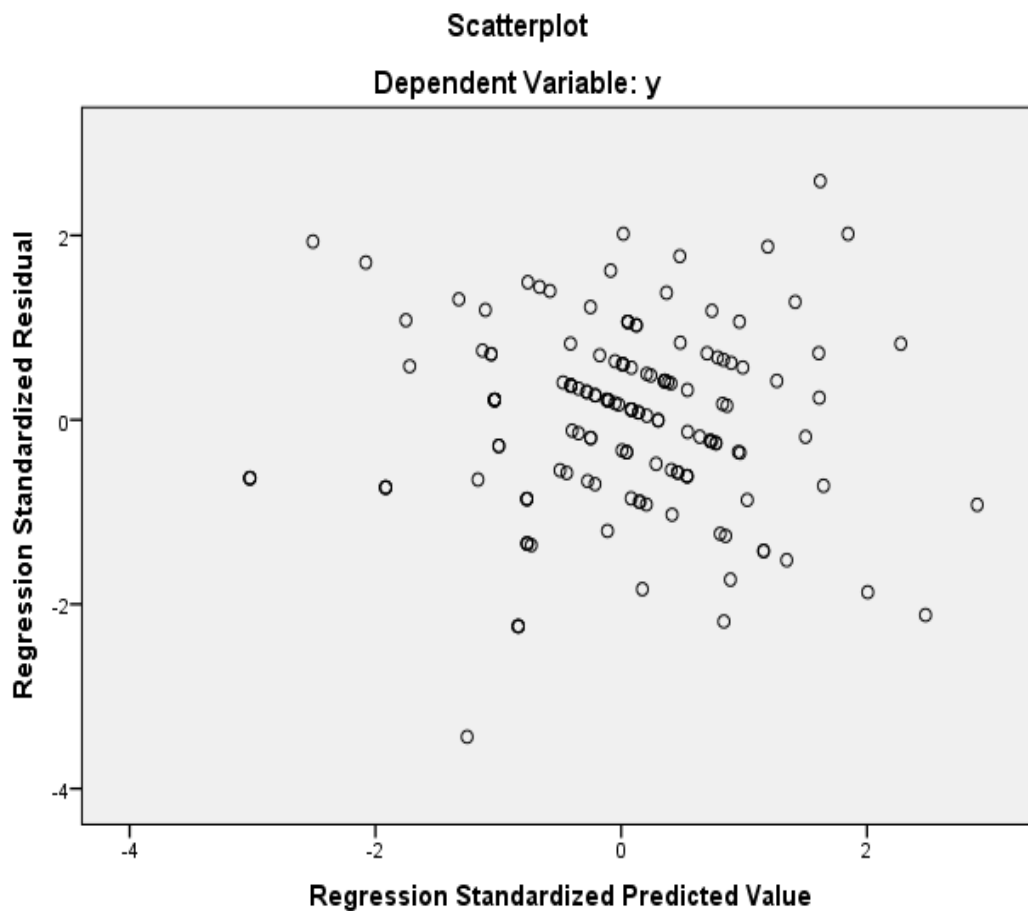


Source; Survey Results and SPSS (2018) output

Heteroscedasticity / presence of Homoscedasticity

We need to show homoscedasticity, which is where the variances along the line of best fit remain similar as you move along the line. As we see from the following plots of the residual and predicted residual the scatter plots are spread without any pattern. This assures the data have no heteroscedasticity problem.

Figure 3.2 Residual and predicted residual the scatter plots



Source; Survey Results and SPSS (2018) output

Multicollinearity

The information in the table above also allows us to check for multicollinearity in our multiple linear regression models. Tolerance should be > 0.1 (or $VIF < 10$) for all variables, which they are. Since all VIF is less than 10 there is no multicollinearity problem

Table 3.3 Multi-co linearity test

Model	Collinearity Statistics	
	Tolerance	VIF
(Constant)		
1 control activities	.625	1.599
Risk assessment	.458	2.186
Monitoring	.364	2.744
corporate governance	.446	2.243

Source; Survey Results and SPSS (2018) output

Auto correlation

Durbin Watson test has been conducted to test presence of auto correlation among variables. According to Durbin Watson significant table ranges in value 0 to 4. A value near 2 indicates non-auto collinearity. A value towards 0 indicates positive auto correlation; a value towards 4 indicates negative auto correlation. So the table for assessment of auto correlation indicates a value of Durbin-Watson $d = 1.864$ which is between the two critical values of $1.5 < d < 2.5$. Therefore that suggests there is no auto correlation problem.

Table 3.4 Autocorrelation test

Durbin- Watson	1.864
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Source; Survey Results and SPSS (2018) output

A study was conducted on the relationship between internal control system and performance of commercial banks in Ethiopia. The analysis applied the statistical package for social sciences (SPSS) to compute the measurements of the multiple regressions for the study. The study evaluated the independent variables and the dependent using questionnaires.

3.3.2 QUALITATIVE ASPECT OF THE STUDY

Qualitative research approach is a means for exploring and understanding individuals or groups scribe to a social or human problem (Creswell, 2014). Qualitative research is typically used to answer questions of complex phenomena. Thus, in the current study qualitative aspect was intended to understand the internal control procedures and approaches used by banks considered in the study.

This was accomplished by face to face interviews held with eight (8) internal audit and internal control managers drawn from the eight banks considered in the study. Face to face interviews were used because of their flexibility, high response rate and also allowing new questions to be brought up during interviews. In addition, as part of the qualitative approach, this study employed documentary analysis. The study reviewed such documents as banks' internal control policy and procedure manuals.

The results of the interviews and documentary reviews were used to supplement data obtained from the quantitative aspect of the study. Qualitative results were analyzed concurrently with the quantitative data.

3.4 CHAPTER SUMMARY AND THE RELATIONSHIP BETWEEN RESEARCH QUESTIONS AND SOURCES OF DATA

This chapter was presented the research questions and the methods appropriate to address them. Table 3.5 sets out how research question was address by the appropriate item in the survey and in interviews.

Table 3.5 the relationship between research questions and sources of data

No	Research question/Hypothesis	Variables	Data source	Specific data to be used
1	The operation of the internal control systems adopted by banks		Survey Questionnaire and interview	questionnaire no.6-9 and interview
2	Relationship between Control activity and financial performance of commercial banks	Control activity and financial performance	Survey Questionnaire	questionnaire no.6&no.10
3	Relationship between Risk assessment and financial performance of commercial bank	Risk assessment and financial performance	Survey Questionnaire	Questionnaire no .7 &no.10

4	Relationship between Monitoring and financial performance of commercial banks	Monitoring and financial performance	Survey Questionnaire	Questionnaire no.8&no.10
5	Relationship between Corporate governance and financial performance of commercial banks	Corporate governance and financial performance	Survey Questionnaire	questionnaire no.9&no.10

In this chapter, the research methodology, research approach, methods of data collection, sampling procedure and data analyzing techniques are discussed. The link of research model and conceptual framework adopted in this particular study is also presented with proper justification. The method selection is in line with the advantage and disadvantage of research approach and data analysis technique. For this study mixed research approach is opted that helps the researcher to achieve the research objectives and the required data is collected through interview and survey of Survey Questionnaire. With this end, the next chapter discuss about results and discussion.

CHAPTER FOUR

RESULTS AND DISCUSSION

The previous chapter presented the methodology used in the thesis. More specifically, the chapter was showed the different research approaches, methods of data collection, and analysis adopted in the study.

This chapter presents the results of the various data collection methods and analysis in the context of the existing knowledge reviewed in chapter two. Accordingly, this chapter is arranged into four sections; the first section (4.1) presents results of the different data sources. This is followed by the discussion of results in the context of the knowledge in the literature as reviewed in chapter two in section (4.2). Finally, Summary for the chapter presented in section (4.3)

4.1 RESULTS OF THE STUDY

One of the purposes of this study was to investigate the relationship between internal control system and financial performance of commercial banks in Ethiopia. The principal data sources to this end were the survey result, document reviews and interview conducted to internal audit, finance and internal control department manager and employees. The following discussion was presented the survey result, document reviews and interview. Therefore in section 4.1.1 was presented survey result while in section 4.1.2 was presented document review .Finally, interview result was presented 4.1.3.

4.1.1 SURVEY RESULTS

In light of the above idea, the purpose of this section was to show the results from survey that conducted in commercial banks in Ethiopia internal audit, finance and internal control department employees. Therefore, it covers the respondents' profiles and Descriptive Statistics in section 4.1.1.1.and 4.1.1.2, finally Regression result was presented in 4.1.1.3

4.1.1.1 RESPONDENTS' PROFILE

The respondent's profiles to this regard consist of gender, respondent age, educational level (academic qualification), field of study, and working experience in a banking sector.

The gender of the respondents was sought. Majority (78.7%) of the respondents were male while the rest (21.4%) of the respondents were female as shown in table 4.1.

Table 4.1 Gender Categories of the Respondents

	Frequency	Percent
Male	170	78.7
Female	46	21.4
Total	216	100.0

Source; Survey Results and SPSS (2018) output

The age of the respondents was sought. Majority (35.18%) of the respondents were 40-49 years old, 32.41% of the respondents 30-39 years old, 18.52 % of the respondents 50 and above 50 years old and the rest was 20-29 years old as shown in table 4.2.

Table 4.2 Age of the Respondents

	Frequency	Percent
20-29 Years	30	13.89
30-39 years	70	32.41
40-49 years	76	35.18
50 or more years of age	40	18.52
Total	216	100

Source; Survey Results and SPSS (2018) output

In terms of educational background, the respondents indicated their highest level of education. According to their response, 80.08% of the respondents obtained a bachelor degree as their highest educational level. In addition, 17.12% of the respondents obtained a post graduate degree or masters as their highest level of education. The remaining respondents obtained diploma as shown in table 4.3.

Table 4.3 Education Background of the Respondents

	Frequency	Percent
College diploma holder	6	2.8
Bachelor's degree holder	173	80.08
Master's degree and above	37	17.12
Total	216	100.0

Source; Survey Results and SPSS (2018) output

Thus the survey made to assess the areas of current working position of the respondents presented in table 4.4 indicated that 47.22 % of the respondents were internal auditor, 46.3% of the respondent were finance employees and the reaming were internal control .

Table 4.4 Current working position of the Respondents

	Frequency	Percent
Internal auditor	102	47.22
Internal controller	14	6.48
Finance employee	100	46.3
Total	216	100.0

Source; Survey Results and SPSS (2018) output

According to survey result the respondents working experiences in a banking sector ranged from the past five year up to above ten years. 35.65% of the respondents had above ten years working experience in a banking sector, 31.94 % of the respondents had above five years less than ten years working experience in a banking sector, 32.41% of the respondents had the past five year working experience in a banking sector as shown in table 4.5.

Table 4.5 Experiences of the Respondents

	Frequency	Percent
For the past five year	70	32.41
6 – 10 years	69	31.94
More than 10 years	77	35.65
Total	216	100.0

Source; Survey Results and SPSS (2018) output

4.1.1.2 DESCRIPTIVE STATISTICS

This section presents the descriptive statistics for all the variables considered in the regression estimation. The dependent variable, as noted earlier, was perception of performance while the independent variables were perceptions of internal control activities, Risk assessment, monitoring and corporate governance. As stated previously, the dependent and independent variables were measured taking the average responses to the relevant statements for each (see details on the measurement variables in Appendix V)

Table 4.6 Descriptive statistics on independent and dependent variable

	N	Minimum	Maximum	Mean	Std. Deviation
Control activities	216	1.60	5.00	3.54	0.79
Risk assessment	216	1.80	5.00	3.67	0.88
Monitoring	216	1.00	5.00	3.63	0.86
Corporate governance	216	1.50	5.00	3.66	0.87
Performance	216	2.00	5.00	3.53	0.71
Valid N (list wise)	216				

(Strongly disagree (1), disagree (2), neutral (3), agree (4) and strongly agree (5)).

Source; Survey Results, SPSS (2018) output and Own Computation

In the Table 4.6, the researcher set out to examine the independent variables such as control activities, risk assessment, monitoring and corporate governance and the dependent variables (performance). The test statements were equally ranked in terms of their mean and standard deviation as a way of interpreting the results. The details of the survey in this regards was discussed as follows;

From the above findings, it was observed that control activities had mean value of more than 3 showing that respondents tended to agree with statements used to measure this variable ($\bar{x}=3.54$ and $S=.79$). In terms of risk assessment the sample mean was found to be more than 3 showing respondents tended to agree with the statements used for this variable ($\bar{x}= 3.67$ and $S=.88$). Similarly, for monitoring the average responses were more than 3 ($\bar{x} =3.63$ and $S= .86$), and corporate governance had mean value more than 3.5 ($\bar{x}=3.66$ and $S= .87$). Finally performance had sample mean value of more than 3 points ($\bar{x}=3.53$ and $S=.71$) (details of these are shown in Appendix IV).

4.1.1.3 REGRESSION RESULT

A study was conducted on the relationship between internal control system and performance of commercial banks in Ethiopia. The analysis applied the statistical package for social sciences (SPSS) to compute the measurements of the multiple regressions for the study. The study evaluated the independent variables and the dependent using questionnaires. The results were as shown below:

Model Summary

The model summary shows the summary of the regression analysis as shown in the regression model present in table 4.7

Table 4.7: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.750 ^a	.562	.554	.28506	1.864

a. Predictors: (Constant), corporate governance, monitoring, Risk assessment, control activities

b. Dependent Variable: Financial Performance

Source; Survey Results and SPSS (2018) output

Analysis of Variance

The study conducted an Analysis of Variance, in order to test the impact of the relationship between internal control system and financial performance of commercial banks in Ethiopia. The results were as shown in table 4.8.

Table 4.8: ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	22.000	4	5.500	67.686	.000 ^b
	Residual	17.145	211	.081		
	Total	39.145	215			

a. Dependent Variable: Financial Performance

b. Predictors: (Constant), corporate governance, monitoring, Risk assessment, control activities

Source; Survey Results and SPSS (2018) output

Test for Coefficients

This table shows the level of significance on the variables, it also provides the standardized and unstandardized coefficients are shown below:

Table 4.9 Test for Coefficients

Model		Coefficients ^a			t	Sig.
		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta		
1	(Constant)	.018	.230		.078	.938
	control activities	.337	.083	.279	4.083	.000
	Risk assessment	.124	.063	.132	1.961	.051
	Monitoring	.099	.071	.080	1.383	.168
	corporate governance	.396	.081	.368	4.880	.000

a. Dependent Variable: Financial Performance
Source; Survey Results and SPSS (2018) output

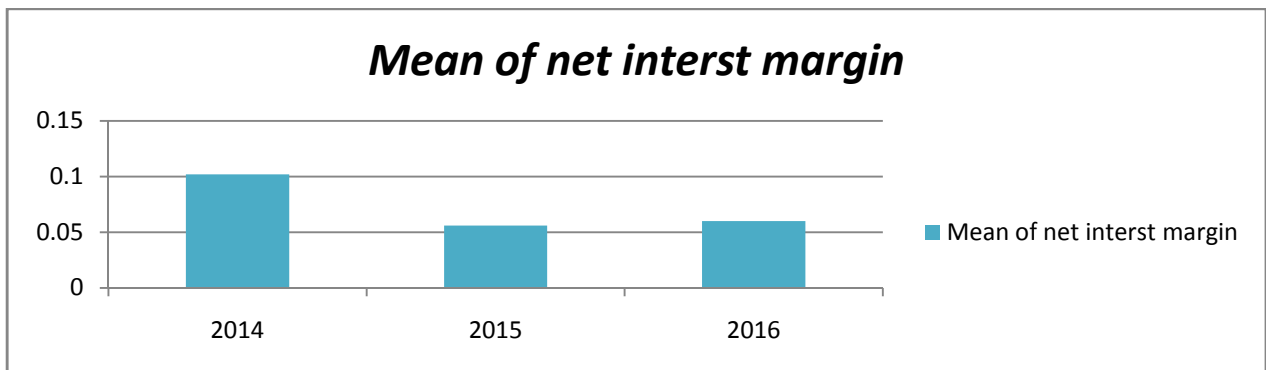
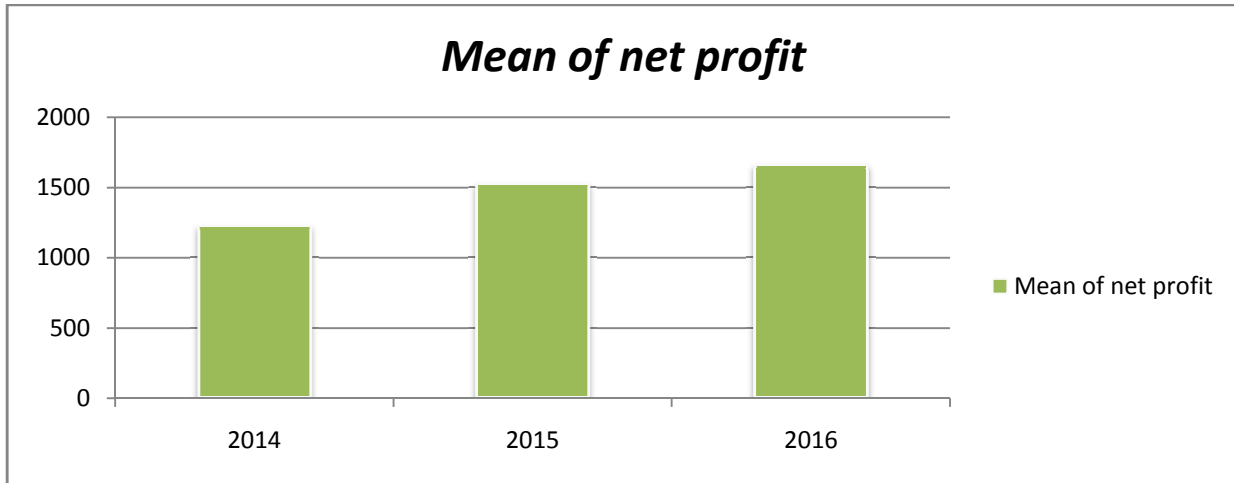
From the above table 4.9, the researcher sought to establish the extent to which internal control impact on performance of commercial banks in Ethiopia". The following regression equation was obtained:

$$P = .018 + .337X_1 + .124 X_2 + .099X_3 + .396 X_4$$

4.1.2. FINANCIAL PERFORMANCE: A REVIEW OF RECORDS

In addition to data obtained through survey of selected staff working in the commercial banks considered for this study, data was acquired through a review of banks financial records. The data was obtained from National Bank of Ethiopia and commercial bank of Ethiopia; the data include mean of net profit and mean of net interest margin

Figure 4.1 Mean of net profit, Mean of net interest margin



Source: National Bank of Ethiopia and commercial bank of Ethiopia and own computation.

From the above graph 4.1 as showed that the mean of the net profit of commercial banks from 2014 to 2016 increased steadily. It was also supported to the survey result. On the other hand the mean of net interest margin of commercial banks from 2014 to 2016 show that in 2015 decreased and also increase 2016.it was fluctuated from survey result also shows that mean of net interest margin was 3.4 that means somehow above neutral .

4.1.3 INTERVIEW RESULTS

As stated in chapter 3, apart from the survey, this study employed interviews with internal audit and internal control department managers. The interviews aimed at obtaining internal auditor and internal

control manager perception of the fairness on the internal control system. Internal auditors and internal control managers from different banks participated in the interviews to assess divergent views and arguments from different angles. The following section presents the results of interviews with 8 internal auditor and internal control manager.

As far as this study is concerned on the issues of internal control system, the participant's had reflected mixed ideas. Accordingly, from the different internal control system dimension, six of interviewees showed that appropriate control structure is set up, with control activities defined at every business level. These should include: top level reviews; appropriate activity controls for different departments or divisions; physical controls; checking for compliance with exposure limits and follow-up on non-compliance; a system of approvals and authorizations; and, a system of verification and reconciliation and also identifies and considers internal factors (such as the complexity of the organization's structure, the nature of the bank's activities, the quality of personnel, organizational changes and employee turnover) as well as external factors (such as fluctuating economic conditions, changes in the industry and technological advances) that could adversely affect the achievement of the bank's goals in assessing risk.

In addition to that six of participant of the interview said that banks internal control system met the required goal of the company, banks have effective internal control system and as a system is well-designed on control activities, risk assessment, monitoring and corporate governance but there is not fully practicable, whereas the rest are not.

Finally 5 of the participants in the interview said that banks internal control system was sufficiently and effectively contribute to performance and that a well-designed control system reduce the occurrence of fraud.

4.2 DISCUSSION

In light of the above idea, the purpose of this section was to show the discussion of a survey result and interviews results. This was organized as follows; firstly presented internal control activities and financial performance. This was followed by risk assessment and performance in Section 4.3.2. Section 4.3.3 was provided monitoring and financial performance. Finally, corporate governance and financial performance was presented in section 4.3.4

Respondent profile result was indicated that the respondents were at adequate education level to understand the concept of internal control system.

Experience is one of the fundamental capacities to understand internal control system in an organization. As it is stated in the control environment of COSO 2013 principles demonstrating commitment to competence is the key for the effective implementation of internal control system. The experienced and competent employees are the more they understand about internal controls they were exercising. According to survey result the respondents working experiences 35.65% of the respondents had above ten years working experience. The implication is the more the employees have experience in their profession the more they have knowledge to apply specific internal control procedures in their duty.

Finally, internal control monitor is primarily the responsibility of auditor. The broader category of internal control is operational and accounting control. Obviously the respondents are auditor and finance employees understand the concept of internal control system than others. In general the respondents profile indicates that the respondents were good enough to respond to the questionnaire and they had the knowledge and experiences to understand internal control system.

In order to, explain the percentage of variation in the dependent variable financial performance as explained by the independent variables. The researcher used coefficient of determination that was obtained from the model summary in the table 4.9. Coefficient of determination was used to explain whether the model is a good predictor.

From the results of the analysis, the findings show that the independent variables (Control Activities, Risk Assessment, monitoring and corporate governance) contributed to 55.4% of the variation in performance as explained by adjusted R² of 0.554 which shows that the other variables not included in this study. This study depends on participant's perception which collected through questionnaire. Therefore, r-squared value more than 25% can be respectable and good to fit (Reisinger, 1997; Thompson, 2002).

In addition to that the results of the findings in analysis of variance in table 4.8 revealed that the level of significance was .000(b) this implies that the regression model is significant in predicting the relationship between internal control and financial performance. By the help of an F-test table, the tabulated value for F (5%, 4, and 216) is 3.41-- which was less than 67.686 meaning that the model was statistically significant.

4.2.1 INTERNAL CONTROL ACTIVITIES AND FINANCIAL PERFORMANCE

Control activities from survey result it was observed that, there was adequate segregation of duties in the banks finance and accounts departments, Staff members are trained to implement the accounting and financial management systems ,there is an up-to-date asset register, Authorization was made to know whether employees confirm to effective and adequate operation, Departments have budget reviews where actual expenditure was compared with budgeted expenditure and explanations for the variances given and also Bank reconciliations was prepared by someone independent of the cash receiving, processing and recording activities . The overall mean of control activities was approximated to 3.54 which indicate an agreement in practices of control activities and the overall standard deviation was approximated to 0.79 this shows that there is a clear variation in the responses provided by the respondents about the existence of the control activities but rooms for improvement. It was also supported by the interview result and the control activities as a system is well-designed on control activities but there is not fully practicable.

Basel (1998) stated that an effective internal control system requires that an appropriate control structure is set up, with control activities defined at every business level. These should include: top level reviews; appropriate activity controls for different departments or divisions; physical controls; checking for compliance with exposure limits and follow-up on non-compliance; a system of approvals and authorizations; and, a system of verification and reconciliation. The failure by the Institution to provide budget reviews is at odds with Ray and Pany (2001) recommendation for “performance reviews” where he recommends comparing actual performance with budgets, forecasts and prior period performance.

So these results shows that most commercial banks observed control activities was a clear indication of existence of good internal control system even if there was a weakness in adequate control activities on Purchase, cash receipt and cash payments, petty cash management, payroll, fixed asset and electronic data processing activities .

From regression result in table 4.9also observed that control activities have a positive coefficient that means that all other thing constant a unit increase in control activities the financial performance was increased by .337.These shows that a strong relationship between the financial performances and control activates, the positive beta sign and a statistically significant result of control activities related with the performance ($\beta = .337$, $t = 4.083$, $P < 0.05$) support the proposed hypothesis acceptable.

Therefore, this in turn strongly supports the first proposed hypothesis (H1) there is a relationship between perceived internal control activities and financial performance of commercial banks and consistence with the previous internal control researches (Jhonkan 2016,Kamau 2014) but inconsistence (Rhale2017,Ndifon and Patrick(2014)

4.2.2 RISK ASSESSMENT AND FINANCIAL PERFORMANCE

Risk assessment from survey result observed that, the management identifies risks that affect achievement of the objectives, the management has a criteria for ascertainment of which fraud-related risks to the organization are most critical, Management ensures that risk identification considers both internal and external factors and their impact on the achievement of objectives, There is adequate capacity to perform risk assessments. It was also established that the management had put in place mechanisms for mitigation of critical risks that may result from fraud. The overall mean of risk assessments was approximated to 3.67 which indicate an agreement in practices of risk assessments and the overall standard deviation was approximated to 0.88 this shows that there is a clear variation in the responses provided by the respondents about the existence of the risk assessments but rooms for improvement. It was also supported by the interview result and risk assessment as a system is well-designed on risk assessment but there is not fully practicable.

According to Dubihlela and Lisa (2017) stated that risk management activities protect the organization, its people, assets, and profits, against the physical and adverse consequences, by planning, coordinating and directing the internal risk control and the risk mitigation activities. So these results shows that most commercial banks observed risk assessment was a clear indication of existence of good internal control system even if there was a weakness in management has put in place mechanisms for mitigation of critical risks that may result from fraud.

From regression result in table 4.9 also observed that Risk assessment have a positive coefficient that means that all other thing constant a unit increase in risk assessment the financial performance was increased by .124 .These shows that a relationship between financial performances and risk assessment, the positive beta sign and a statistically significant result of risk assessment related with the performance ($\beta =.124$, $t =1.961$, $P>0.05$) so this result is not support the proposed hypothesis acceptable at 5% significant level but it is acceptable at 10% significant level.

Therefore, this in turn is not supports the second proposed hypothesis (H2)there is a relationship between perceived Risk Assessment and financial performance of commercial banks, and in

consistence with the previous internal control researches (Jhonkan 2016, Kamau 2014) but consistence with (Rhale 2017)

4.2.3 MONITORING AND FINANCIAL PERFORMANCE

Monitoring from survey result observed that, Internal reviews of implementation of internal controls in units are conducted periodically, Management has assigned responsibilities for the timely review of audit reports and resolution of any non-compliance items noted in those audit reports, Bank's financial statements are audited regularly by external auditor. The overall mean of monitoring was approximated to 3.63 which indicate an agreement in practices of monitoring and the overall standard deviation was approximated to 0.86 this shows that there is a clear variation in the responses provided by the respondents about the existence of the monitoring but rooms for improvement. It was also supported by the interview result and monitoring as a system is well-designed on monitoring but there is not fully practicable.

According to the frame work for internal control system in banking organization (1998) stated that the overall effectiveness of the bank's internal controls should be monitored on an ongoing basis. So this result shows that most commercial banks observed monitoring system was a clear indication of existence of good internal control system even if there was a weakness in independent process checks and evaluations of controls activities on ongoing basis.

In the contrary the third proposed hypothesis (H3) there is a relationship between perceived Monitoring and financial performance of commercial banks were not supported by the regression result. As of the regression results insignificant related with the financial performance at ($P < 0.05$). As shown in table 4.8 above. The coefficient of monitoring ($\beta = .099$) were positively related but statistically ($t = 1.383$, $p > 0.05$) not significant related with the financial performance. But, this result was inconsistence with the previous internal control researches (Jhonkan 2016, Rhahel 2017) they argued that there were a relation between monitoring and financial performance.

4.2.4 CORPORATE GOVERNANCE AND FINANCIAL PERFORMANCE

Corporate governance from survey result observed that the company has a well-established and effective Board, Recruitment and appointment of Board members is approved by the Shareholders during the Annual General Meetings, All members of the board of directors belong to various specialized sub-committee of the board. The overall mean of corporate governance was approximated

to 3.66 which indicate an agreement in practices of corporate governance and the overall standard deviation was approximated to 0.87 this shows that there is a clear variation in the responses provided by the respondents about the existence of corporate governance but rooms for improvement. In addition to that it was also supported by the interview result and the corporate governance as a system is well-designed on corporate governance but there is not fully practicable.

The code of corporate governance highlights the need for a firm to maintain a good system of internal controls in order to manage the risks that the firm is prone to. So this result shows that most commercial banks observed corporate governance clear indication of existence of good internal control system even if there was a weakness well established corporate governance policies and procedures and practices that guide the affairs of the company.

From regression result in table 4.9 also observed that corporate governance have a positive coefficient that means that all other thing constant a unit increase in corporate governance financial performance was increased by .396. The regression result also was supports the fourth proposed hypothesis (H4)there is a relationship between perceived corporate governance and financial performance of commercial banks at ($P < 0.05$) level of significant and with the positive signs of beta and t statistics ($\beta = .396$ and $t = 4.880$). But, this result was consistence with the previous internal control researches (Jhonkan 2016) they argued that there were a relation between corporate governance and financial performance.

4.3CHAPTER SUMMARY

To sum up, the discussions in this chapter endeavored to integrate the results of the quantitative and qualitative methods so as to address the specific research question and hypotheses and achieve the objectives of the research holistically. However, the findings in this study are not without weaknesses. The subsequent chapter, thus, presents the strengths and weaknesses of the study coupled with implications to the commercial banks.

CHAPTER FIVE

CONCLUSION AND RECOMMENDATIONS

The purpose of this chapter is to pinpoint the major findings of the study and indicate recommendations that can help in improvement of internal control system in commercial banks of Ethiopia. Thus the chapter is organized as section 5.1. Conclusion which presents major findings of the study, and section 5.2 which presents recommendations based on the findings.

5.1. CONCLUSION

Internal control is 'a process, effected by the entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives' effectiveness and efficiency of operation, Reliability of financial reporting and Compliance with applicable laws and regulations. All commercial banks need a guarantee of the internal control system in their banks to be effective enough in attaining such objectives. As indicated in literature, customarily the management of organizations performs this task through monitoring the effectiveness of internal control they designed.

Based on these ground the study aimed to assess whether there is an effective internal control system, identify areas of deficiency, and there to indicate areas of emphasis to improve the internal control system. To achieve these objectives a survey method is employed in quantitative approach. The survey method used questionnaires to employees in the commercial banks and analyzed through descriptive and inferential statistics analysis. A qualitative research approach used in the study used semi structured interviews with internal audit and internal control manager. The questionnaires were aimed to examine whether components of internal controls were adequately practiced in the commercial banks. The interview was also used to gather additional information on the strength and weaknesses of internal control system in the commercial banks.

The detailed findings and areas of deficiencies in internal control are summarized as follows.

First, the finding on the relationship between control activities and perception of financial performancethe results indicated that it was good in adequate segregation of duties ,review financial transactions , staff training , up-to-date asset register , Authorization , budget reviews ,Bank reconciliations. But there was a weakness in adequate control activities on Purchase, cash receipt and cash payments, petty cash management, payroll, fixed asset and electronic data processing

activities. The findings of the study also found that control activities had a positive and significant relationship with financial performance.

Secondly, the finding on the relationship between Risk assessment and perception of financial performance the results indicated that it was good in identifying risks, criteria for ascertainment of which fraud-related risks, risk identification and risk assessments. But there was a weakness in mechanisms for mitigation of critical risks that may result from fraud. The findings of the study also found that risk assessment had a positive and insignificant relationship with financial performance.

Thirdly, the finding on the relationship between monitoring and perception of financial performance the results indicated that it was good in internal reviews of implementation of internal controls in units which are conducted periodically, assessing the quality of performance of the organization over time, assigning responsibilities for the timely review of audit reports and resolution of any non-compliance items noted in those audit reports, internal reviews implementation of Purchase, cash receipt and cash payments, petty cash management, payroll, fixed asset and electronic data processing, etc. in accordance with the policies and the procedures, and Bank's financial statements audited regularly by external auditor. But there was a weakness in independent process checks and evaluations of controls activities on ongoing basis. The findings of the study also found that monitoring had insignificant relationship with financial performance.

Fourthly, the finding on the relationship between corporate governance and perception of financial performance the results indicated that it was good in a well-established effective Board, Recruitment and appointment of Board member and all members of the board of directors belong to various specialized sub-committee of the board. But there was a weakness in well-established corporate governance policies and procedures and practices. The findings of the study also found that corporate governance had a positive and significant relationship with financial performance.

Finally the relationship between internal control system and financial performance from inferential static result observed that, based on the coefficients of the independent variable (β sign) four hypotheses proposed by the researcher are acceptable because of four hypotheses stated the positively relationship with the dependent variable are meet. But based on the statistical significances of the independent variable over the dependent variable at 5% level of significance, only two independent variables (internal control activities and corporate governance) are significantly contributed for financial performance at ($P < 0.05$) level of confidence.

From the above findings, what the thesis generally concludes that control activities and corporate governance are the most important determinants of financial performance in commercial banks in Ethiopia and should give more emphasis in their internal control system function.

5.2. RECOMMENDATIONS

Internal controls help you keep your business operating smoothly and ensure that your financial records can be trusted. They're an important part in building a trustworthy and reliable company. However, internal controls can't guarantee that everything will go according to plan. This implies the inherent limitations of internal control; that internal control is designed, operated and monitored by human beings. However, it is possible to improve internal control system through continuous monitoring, related risk assessment, designing sound control activities methods and with a good corporate governance. From the findings of the study it is possible to conclude that there is internal control system, but it is a need for improvement in control activities, risk assessment, monitoring and corporate governance.

So the study recommended that commercial banks risk management team should design mechanisms such as Raise Fraud Awareness, Employ Dual, Triple Controls and Multi-Factor Authentication for mitigation of critical risks that may result from fraud and continuous working in related risk assessment.

And also the commercial banks internal audit unit can contribute much to assure the effectiveness of internal control system through making independent process checks and evaluations of controls activities on ongoing basis.

Finally, the studies recommended that Ethiopian commercial banks improve internal control system through continuous monitoring, related risk assessment, designing sound control activities methods and with a good corporate governance to improve financial performance.

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APPENDIX I: QUESTIONNAIRE

Addis Ababa University
College of Business and Economics
Department of Accounting and Finance

Dear Participant,

This project is entitled “Perception on Internal Control system and financial performance in commercial banks”. The investigator is Sebleworku who is currently an Msc (in Accounting and Finance) student at Addis Ababa University.

The aim of this project is to examine the existing internal controls system and its impact on performance in commercial banks. To supplement the data obtained from different sources, the investigator seeks to gather relevant information from a sample of 8 commercial banks using self-administered questions using structured questionnaire.

Participation in this project is completely voluntary, the questionnaire results will be recorded anonymously and strict confidentiality will be maintained. Individual responses will not be identified in the investigator’s Msc thesis.

For further information please contact Sebleworku by the following address.

Email: - sebleworku44@yahoo.com

I. Personal information of the respondent

1. Gender: Male----- 1 Female ----- 2

2. Respondents 'Age:

19 years or less ----- 1

20–29 years----- 2

30–39 years----- 3

40–49 years-----

50 or more years of age ----- 5

3. Educational background:

High school or equivalent completed -----

Vocational/technical school completed----- 2

College diploma holder----- 3

Bachelor's degree holder-----

Master's degree and above----- 5

Others----- 6, please
specify.....

4. What is yourCurrent working position?

Internal control employees----- 1

Auditor----- 2

Finance employees----- 3

5. How long have you been working in your current position

For the past five year ----- 1

6 – 10 years ----- 2

More than 10 years----- 3, please
specify.....

II. Internal Control Systems (ICS)

6. Please, tick in the appropriate box to extent to which your organization practices the following control activities

CONTROL ACTIVITY	Strongly disagree(1)	Dis agree(2)	Neutral(3)	Agree(4)	Strongly agree(5)
There is adequate segregation of duties in the banks finance and accounts departments.					
Staff are train to implement the accounting and financial management systems.					
There is an up-to-date asset register					
Authorization will be made to know whether employees confirm to effective and adequate operation					
Departments have budget reviews where actual expenditure is compared with budgeted expenditure and explanations for the variances given					
Bank reconciliations are prepared by someone independent of the cash receiving, processing and recording activities					
There is adequate control activities on Purchase, cash receipt and cash payments, petty cash management, payroll, fixed asset and electronic data processing activities					

7. Please, tick in the appropriate box to extent to which your organization's management is involved in risk assessment the extent to which your organization's management is involved in risk assessment

RISK ASSESSMENT	Strongly disagree (1)	Disagree (2)	Neutral (3)	Agree (4)	Strongly agree (5)
Management identifies risks that affect achievement of the objectives					
Management has a criteria for ascertainment of which fraud-related risks to the organization are most critical					
Management has put in place mechanisms for mitigation of critical risks that may result from fraud					
Management ensures that risk identification considers both internal and external factors and their impact on the achievement of objectives					
There is adequate capacity to perform risk assessments					

8. Please, tick in the appropriate box to extent to which the following statements relate to your organization's monitoring procedures

Monitoring	Strongly disagree (1)	Disagree (2)	Neutral (3)	Agree (4)	Strongly agree (5)
There are independent process checks and evaluations of controls activities on ongoing basis					
Internal reviews of implementation of internal controls in units are conducted periodically					

Monitoring has helped in assessing the quality of performance of the organization over time					
Management has assigned responsibilities for the timely review of audit reports and resolution of any non-compliance items noted in those audit reports					
Internal reviews implementation of Purchase, cash receipt and cash payments, petty cash management, payroll fixed asset and electronic data processing, etc in accordance with the policies and the procedures					
Bank's financial statements are audited regularly by external auditor					
Internal control deficiencies, or ineffectively controlled risks, should be reported to the appropriate person(s) as soon as they are identified.					
Monitoring is built into the normal operating activities					
Management of banks reviews long outstanding items in financial statements					
The timing of the audit in this company is appropriate.					

9. Please, tick in the appropriate box to extent to which the following statements relate to your organization's Corporate Governance procedures

CORPORATE GOVERNANCE	Strongly disagree (1)	Dis agree(2)	Neutral (3)	Agree (4)	Strongly agree(5)
The company has a well-established and effective Board					
Recruitment and appointment of Board members is approved by the Shareholders during the Annual General Meetings					
Number of internal board sub-committees affects banks financial performance					
All members of the board of directors belong to various specialized sub-committee of the board					
The company has well established corporate governance policies and procedures and practices that guide the affairs of the company					
Increasing the frequency of the board meeting has impact on bank financial performance					

10. Please, tick in the appropriate box to extent to which the following statements relate to your organization's performance

Financial Performance	Strongly disagree(1)	Dis agree(2)	Neutra l(3)	Agree (4)	Strongly agree(5)
profitability in company over the last 3 year has been increasing					
Return on asset over the last 3 years has been increasing steadily					
Net interest margin in company over the last 3 years has been growing steadily.					
Our institution has enough cash to meet its obligations effectively					
Creditors are paid in time to avoid legal charge					
The profits made by branches is enough to cover their cost of running their operations					

Thank you for your participation

APPENDIX II: INTERVIEW QUESTION

1. Do you believe that, the internal control met the required goal of the banks? (Explain)
2. What is your idea about the effectiveness of the internal control and where is/are areas of the control you suggest for an improvement?
3. Based on your experience, existing internal control system in all areas of internal control system (the control environment, control activities, risk assessment, information and communication, corporate governance, and monitoring) well designed and operating in the banks? (Explain)
4. In your opinion, is the organization's system of internal controls sufficiently and effectively contribute to performance? (Explain)

APPENDIX III: LIST OF BANKS IN ETHIOPIA AS OF 2015-2016

NO	Name of banks	Year of establishment
1	Abay Bank S.C.	2010
2	Addis International Bank	2011
3	Awash International Bank	1994
4	Bank of Abyssinia	1996
5	Berhan International Bank	2010
6	Bunna International Bank	2009
7	Commercial Bank of Ethiopia	1963
8	Cooperative Bank of Oromia	2005
9	Dashen Bank	2003
10	Dehub Global Bank	2012
11	Development Bank of Ethiopia	1909
12	Enat Bank	2013

13	Lion International Bank	2006
14	Nib International Bank	1999
15	Oromia International Bank	2008
16	United Bank	1998
17	Wegagaen Bank	1997
18	Zemen Bank	2009
	Total	

Source: National Bank of Ethiopia Annual Report of 2015/2016 (<http://www.nbe.gov.et>)

APPENDIX IV: DESCRIPTIVE STATISTICS ON CONTROL ACTIVITIES, RISKASSESSMENT, MONITORING, CORPORATEGOVERNANCE AND PERFORMANCE

Table 1 Descriptive statistics on control activities

	N	Minimum	Maximum	Mean	Std. Deviation
There is adequate segregation of duties in the banks finance and accounts departments.	216	2.00	5.00	3.3102	.70288
Staffs are trained to implement the accounting and financial management systems.	216	1.00	5.00	3.7083	.83701
There is an up-to-date asset register	216	2.00	5.00	3.9352	.71883
Authorization will be made to know whether employees confirm to effective and adequate operation	216	2.00	5.00	3.4398	.76923
Departments have budget reviews where actual expenditure is compared with budgeted expenditure and explanations for the variances given	216	2.00	5.00	3.5324	.70140
Bank reconciliations are prepared by someone independent of the cash receiving, processing and recording activities	216	1.00	5.00	3.9769	.84326
There is adequate control activities on Purchase, cash receipt and cash payments, petty cash management, payroll, fixed asset and electronic data processing activities	216	1.00	5.00	2.8657	.93288
Valid N (listwise)	216				

(Strongly disagree (1), disagree (2), neutral (3), agree (4) and strongly agree (5))

Source; Survey Results and SPSS (2018) output

Table 2 Descriptive statistics on Risk Assessment

	N	Minimum	Maximum	Mean	Std. Deviation
Management identifies risks that affect achievement of the objectives	216	2.000	5.000	4.13426	.756696
Management has a criteria for ascertainment of which fraud-related risks to the organization are most critical	216	2.00	5.00	4.0694	.81257

Management has put in place mechanisms for mitigation of critical risks that may result from fraud	216	1.00	5.00	2.6574	1.22122
Management ensures that risk identification considers both internal and external factors and their impact on the achievement of objectives	216	1.00	5.00	3.4398	0.76923
There is adequate capacity to perform risk assessment	216	2.00	5.00	4.0417	.85352
Valid N (listwise)	216				

(Strongly disagree (1), disagree (2), neutral (3), agree (4) and strongly agree (5)).

Source; Survey Results and SPSS (2018) output

Table 3 Descriptive statistics on Monitoring

	N	Minimum	Maximum	Mean	Std. Deviation
There are independent process checks and evaluations of controls activities on ongoing basis	216	1.00	5.00	2.7963	1.15946
Internal reviews of implementation of internal controls in units are conducted periodically	216	1.00	5.00	3.7917	.72697
Monitoring has helped in assessing the quality of performance of the organization over time	216	1.00	5.00	3.7454	1.07183
Management has assigned responsibilities for the timely review of audit reports and resolution of any non-compliance items noted in those audit reports	216	1.00	5.00	3.7222	.88221
Internal reviews implementation of Purchase, cash receipt and cash payments, petty cash management, payroll ,fixed asset and electronic data processing, etc in accordance with the polices and the procedures	216	1.00	5.00	3.7963	.82133
Bank's financial statements are audited regularly by external auditor	216	1.00	5.00	3.4306	.80394
Internal control deficiencies, or ineffectively controlled risks, should be reported to the appropriate person(s) as soon as they are identified.	216	2.00	5.00	3.7685	.66271

Monitoring is built into the normal operating activities	216	1.00	5.00	3.6944	.84587
Management of banks reviews long outstanding items in financial statements	216	1.00	5.00	3.6898	.88454
The timing of the audit in this company is appropriate.	216	1.00	5.00	3.8287	.77358
Valid N (listwise)	216				

(Strongly disagree (1), disagree (2), neutral (3), agree (4) and strongly agree (5)).

Source; Survey Results and SPSS (2018) output

Table 4 Descriptive statistics on corporate governance

	N	Minimum	Maximum	Mean	Std. Deviation
The company has a well-established and effective Board	219	.00	5.00	3.4398	.76923
Recruitment and appointment of Board members is approved by the Shareholders during the Annual General Meetings	216	2.00	5.00	3.5694	.76844
Number of internal board sub-committees affects banks financial performance	216	1.00	5.00	4.0602	.90017
All members of the board of directors belong to various specialized sub-committee of the board	216	2.00	5.00	4.1435	.74880
The company has well established corporate governance policies and procedures and practices that guide the affairs of the company	216	2.00	5.00	2.5434	1.29986
Increasing the frequency of the board meeting has impact on bank financial performance	216	2.00	5.00	4.1944	.72764
Valid N (listwise)	216				

(Strongly disagree (1), disagree (2), neutral (3), agree (4) and strongly agree (5)).

Source; Survey Results and SPSS (2018) output

Table 5 Descriptive statistics on financial performance

	N	Minimum	Maximum	Mean	Std. Deviation
profitability in company over the last 3 year has been increasing	216	2.00	5.00	3.8241	.75117
Return on asset over the last 3 years has been increasing steadily	216	2.00	5.00	3.4398	.76923
Net interest margin in company over the last 3 years has been growing steadily.	216	2.00	5.00	3.5694	.76844
Our institution has enough cash to meet its obligations effectively	216	2.00	5.00	3.5231	.59410
Creditors are paid in time to avoid legal charge	216	2.00	5.00	3.5324	.70140
The profits made by branches is enough to cover their cost of running their operations	216	2.00	5.00	3.3102	.70288
Valid N (listwise)	216				

(Strongly disagree (1), disagree (2), neutral (3), agree (4) and strongly agree (5).

Source; Survey Results and SPSS (2018) output

APPENDIX V: INDEPENDENT AND DEPENDENT VARIABLE MEASUREMENT

Table1

Ser No	Variable description	Measurement items	Nature of the variable
1	Perception of financial performance	<ul style="list-style-type: none"> • profitability in company over the last 3 year has been increasing • Return on asset over the last 3 years has been increasing steadily • Net interest margin in company over the last 3 years has been growing steadily. • Our institution has enough cash to meet its obligations effectively • Creditors are paid in time to avoid legal charge • The profits made by branches is enough to cover their cost of running their operations 	Dependent variable
2	Control activity	<ul style="list-style-type: none"> • There is adequate segregation of duties in the banks finance and accounts departments • Staff are train to implement the accounting and financial management systems 	In dependent variable

		<ul style="list-style-type: none"> • There is an up-to-date asset register • Authorization will be made to know whether employees confirm to effective and adequate operation • Departments have budget reviews where actual expenditure is compared with budgeted expenditure and explanations for the variances given • Bank reconciliations are prepared by someone independent of the cash receiving, processing and recording activities • There is adequate control activities on Purchase, cash receipt and cash payments, petty cash management, payroll, fixed asset and electronic data processing activities 	
3	Risk assessment	<ul style="list-style-type: none"> • Management identifies risks that affect achievement of the objectives • Management has a 	In dependent variable

		<p>criteria for ascertainment of which fraud-related risks to the organization are most critical</p> <ul style="list-style-type: none"> • Management has put in place mechanisms for mitigation of critical risks that may result from fraud • Management ensures that risk identification considers both internal and external factors and their impact on the achievement of objectives • There is adequate capacity to perform risk assessments 	
4	Monitoring	<ul style="list-style-type: none"> • There are independent process checks and evaluations of controls activities on ongoing basis • Internal reviews of implementation of internal controls in units are conducted periodically • Monitoring has helped in assessing the quality of performance of the 	In dependent variable

		<p>organization over time</p> <ul style="list-style-type: none"> • Management has assigned responsibilities for the timely review of audit reports and resolution of any non-compliance items noted in those audit reports • Internal reviews implementation of Purchase, cash receipt and cash payments, petty cash management, payroll ,fixed asset and electronic data processing, etc in accordance with the polices and the procedures • Bank's financial statements are audited regularly by external auditor • Internal control deficiencies, or ineffectively controlled risks, should be reported to the appropriate person(s) as soon as they are identified. • Monitoring is built into 	
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		<p>the normal operating activities</p> <ul style="list-style-type: none"> • Management of banks reviews long outstanding items in financial statements • The timing of the audit in this company is appropriate. 	
5	Corporate governance	<ul style="list-style-type: none"> • The company has a well-established and effective Board • Recruitment and appointment of Board members is approved by the Shareholders during the Annual General Meetings • Number of internal board sub-committees affects banks financial performance • All members of the board of directors belong to various specialized sub-committee of the board • The company has well established corporate governance policies and procedures and practices that guide the affairs of the company • Increasing the frequency of 	In dependent variable

		the board meeting has impact on bank financial performance	
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